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## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying financial statements of the Commonwealth of Massachusetts (Commonwealth) have been prepared in accordance with accounting principles generally accepted in the United States of America, (GAAP). The Governmental Accounting Standards Board (GASB) is the recognized standard-setting body for establishing governmental accounting and financial reporting principles. The significant Commonwealth accounting policies are described below. Except where noted, all numbers in the footnote tables and other sections of this Comprehensive Annual Financial Report are in thousands.

### A. Reporting Entity

The Commonwealth is comprised of three branches: the Executive Branch, with the Governor as the chief executive officer; the Legislative Branch, consisting of a Senate of 40 members and a House of Representatives of 160 members; and the Judicial Branch made up of the Supreme Judicial Court, the Appeals Court and the Trial Court. In addition, the Legislature has established 56 independent authorities and agencies. Below the level of state government are 351 cities and towns exercising the functions of local governments. The cities and towns of the Commonwealth are also organized into 14 counties, but county government has been abolished in seven of those counties in recent years.

For financial reporting purposes, the Commonwealth has included all funds, organizations, account groups, agencies, boards, commissions and institutions. The Commonwealth has also considered all potential component units for which it is financially accountable as well as other organizations for which the nature and significance of their relationship with the Commonwealth is such that exclusion would cause the Commonwealth's financial statements to be misleading or incomplete. As required by GAAP, these financial statements present the Commonwealth of Massachusetts (the primary government) and its component units. The Commonwealth has included 35 entities as component units in the reporting entity because of the significance of their operational and/or financial relationships with the Commonwealth.

#### *Component Units and Details of Departments and Funds that are Separately Audited*

##### *Blended Component Units, Departments and Funds that are Separately Audited*

Blended component units are entities that are legally separate from the Commonwealth, but are so related to the Commonwealth, that they are, in substance, the same as the Commonwealth or entities providing services entirely or almost entirely to the Commonwealth. The net assets and results of operations of the following legally separate entities are presented as part of the Commonwealth's operations:

- **The Pension Reserves Investment Trust Fund (PRIT)** is the investment portfolio for the pension net assets of the Commonwealth and as such, is presented as a blended component unit. PRIT is managed by the Pension Reserves Investment Management (PRIM) Board. Certain portions related to municipal holdings of PRIT are reported as an external investment trust within the fiduciary statement of net assets and statement of changes in net assets.
- **The Health Care Security Trust Account (HCST)** is the long - term investment account of the Health Care Security Trust, a minor governmental fund. The Health Care Security Trust was the ultimate

recipient of tobacco settlement remittances to the Commonwealth from fiscal year (FY) 99 through FY02. The HCST is managed by a board of trustees, which supervises the investment and reinvestment of monies received into the HCST. The HCST utilizes certain resources and staff of PRIT or PRIM. In FY03, certain Medicaid related revenues were also managed by the HCST.

- **The Massachusetts Municipal Depository Trust (MMDT)** is an investment pool of the Commonwealth and its political subdivisions. Portions of MMDT are reported as an external investment trust within the fiduciary statement of net assets and statement of changes in net assets. MMDT is established by the Treasurer – Receiver General, who serves as trustee.

**The following entities are audited separately from the Commonwealth but are not legally separate from the Commonwealth:**

- **The Massachusetts State Lottery Commission** runs the Commonwealth's lottery. The net assets of the Commission and results of operations are presented as part of the Commonwealth's governmental activities.
- **The Commonwealth of Massachusetts Owner Controlled Worker's Compensation and General Liability Insurance Program (OCIP)** provides worker's compensation and general liability insurance for all eligible contractors and subcontractors working on the Central Artery / Tunnel Project. The OCIP is managed by the Massachusetts Highway Department.

**The institutions of higher education of the Commonwealth have operations and net assets that are presented as part of the Commonwealth's business – type activities. These systems include:**

- **The University of Massachusetts System** including its discretely presented component units, the University of Massachusetts Building Authority, the University of Massachusetts Foundation, Inc., and the Worcester City Campus Corporation (doing business as Umass Health System.) The Worcester City Campus Corporation includes a not-for-profit subsidiary, the Worcester Foundation for Biomedical Research, Inc. Finally, the University System includes the University of Massachusetts Dartmouth Foundation, Inc.
- **The State and Community College System** includes 9 State and 15 Community Colleges located throughout the Commonwealth. The following are Community Colleges:
  - Berkshire Community College
  - Bunker Hill Community College
  - Bristol Community College
  - Cape Cod Community College
  - Greenfield Community College

- Holyoke Community College
- Massasoit Community College
- Massachusetts Bay Community College
- Middlesex Community College
- Mount Wachusett Community College
- Northern Essex Community College
- North Shore Community College
- Quinsigamond Community College
- Roxbury Community College
- Springfield Technical Community College

The following are State Colleges:

- Bridgewater State College
- Fitchburg State College
- Framingham State College
- Massachusetts College of Art
- Massachusetts Maritime Academy
- Massachusetts College of Liberal Arts
- Salem State College
- Westfield State College
- Worcester State College

Within the State and Community College system is a blended component unit, The Massachusetts State College Building Authority.

***Discretely Presented Component Units that are Separately Audited*** – Discrete component units are entities which are legally separate (often called Authorities) are financially accountable to the Commonwealth, or whose relationships with the Commonwealth are such that exclusion would cause the Commonwealth's financial statements to be misleading or incomplete. The component units column of the basic financial statements includes the financial data of the following entities:

*Major Component Units:*

- **The Massachusetts Bay Transportation Authority (MBTA)** provides mass transit facilities within the Greater Boston metropolitan area, comprising 175 cities and towns.
- **The Massachusetts Turnpike Authority (MTA)** operates the Massachusetts Turnpike and the Boston Harbor Tunnel crossings that are part of the Metropolitan Highway System.
- **The Massachusetts Water Pollution Abatement Trust (MWPAT)** provides a combination of federal and Commonwealth funds for water and sewer projects around the Commonwealth as operator of the Commonwealth's state revolving fund.

*Minor Component Units*

- **The Massachusetts Convention Center Authority (MCCA)**
- **The Massachusetts Development Finance Agency (MassDevelopment)**
- **The Massachusetts Technology Park Corporation (MTPC)**
- **The Massachusetts Community Development Finance Corporation (MCDFC)**
- **Commonwealth Corporation**
- **The Massachusetts International Trade Council, Inc. (MITC)**
- **The Community Economic Development Assistance Corporation (CEDAC)**

- **The Massachusetts Housing Partnership (MHP)**
- **Route 3 North Transportation Improvements Association (R3N)**
- **The Commonwealth Zoological Corporation**
- **The Regional Transit Authorities (15 separate entities) including:**
  - Berkshire Regional Transit Authority
  - Brockton Area Transit Authority
  - Cape Ann Transit Authority
  - Cape Cod Regional Transit Authority
  - Franklin Regional Transit Authority
  - Greater Attleboro / Taunton Regional Authority
  - Greenfield-Montague Transportation Area
  - Lowell Regional Transit Authority
  - Martha's Vineyard Transit Authority
  - Merrimack Valley Regional Transit Authority
  - Montachusett Regional Transit Authority
  - Nantucket Regional Transit Authority
  - Pioneer Valley Regional Transit Authority
  - Southeastern Regional Transit Authority
  - Worcester Regional Transit Authority

#### *Related Organizations*

The following are “related organizations” under GASB Statement No. 14, “*The Financial Reporting Entity*”: Massachusetts Port Authority, Massachusetts Housing Finance Agency, Massachusetts Health and Educational Facilities Authority and Massachusetts Technology Development Corporation. The Commonwealth is responsible for appointing a voting majority of the members of each entity’s board, but the Commonwealth’s accountability does not extend beyond the appointments.

#### *Availability of Financial Statements*

The Commonwealth’s component units, departments and funds that are separately audited issue their own financial statements. These statements may be obtained by directly contacting the various entities. To obtain their phone numbers, you may contact the Office of the State Comptroller, Financial Reporting and Analysis Bureau, at (617) 973-2660.

### **B. Government – Wide Financial Statements**

The Statement of Net Assets and the Statement of Activities report information on all non-fiduciary activities of the primary government (the Commonwealth), and its component units. Primary government activities are defined as either governmental or business-type activities. Governmental activities generally are financed through taxes, intergovernmental revenues and other non-exchange revenues. Business-type activities are financed in whole or in part by fees charged to external parties for goods or services.

#### *Government – Wide Financial Statements*

The **Statement of Net Assets** presents all of the reporting entity’s non-fiduciary assets and liabilities, with the difference reported as net assets. Net assets are reported in three categories:

- **Invested in capital assets, net of related debt** consists of capital assets, net of accumulated depreciation and reduced by outstanding balances for bonds, notes and other debt that are attributed to the acquisition, construction or improvement of those assets.

- **Restricted net assets** result when constraints placed on net asset use are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through enabling legislation.
- **Unrestricted net assets** consist of net assets, which do not meet the definition of the two preceding categories. Unrestricted net assets often are designated, (for example, internally restricted), to indicate that management does not consider them to be available for general operations.

The **Statement of Activities** demonstrates the degree to which the direct expenses of a given function or segment are offset by program revenues. Direct expenses are those that are clearly identifiable within a specific function. Program revenues include charges to customers or applicants who purchase, use, or directly benefit from goods, services, or privileges that are restricted to meeting the operational or capital requirements of a particular function. Taxes and other items not meeting the definition of program revenues are instead reported as general revenue.

**C. Fund Financial Statements**

The fund financial statements present a balance sheet and a statement of revenues, expenditures and changes in fund balances for its major and aggregated non-major funds.

Separate financial statements are provided for governmental funds, proprietary funds and fiduciary funds. Major individual governmental funds and major individual proprietary funds are reported as separate columns in the fund financial statements pursuant to GASB reporting standards, with non-major funds being combined into a single column.

**D. Measurement Focus and Basis of Accounting**

The Commonwealth reports its financial position and results of operations in funds, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a set of self-balancing accounts that comprise its assets, liabilities, fund equity, revenues and expenditures/expenses. Transactions between funds within a fund type, if any, have not been eliminated.

**Governmental Activities – Government –wide financial statements** - are reported using the economic resources management focus and the full accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of cash flows. Grants and similar items are recognized as revenues as soon as all eligibility requirements imposed by the provider have been met.

**Governmental Funds – Fund Financial Statements** - account for the general governmental activities of the Commonwealth. Governmental fund statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized as they become *susceptible to accrual*; generally when they are both measurable and available. Revenues are considered to be available when they are collected within the current period or soon enough thereafter to pay liabilities of the current period. Significant revenues susceptible to accrual include income, sales and use, corporation and other taxes, federal grants, federal reimbursements and other reimbursements for use of materials and services. Revenues from other financing sources are recognized when received. Expenditures are recorded in the period in which the related fund liability is incurred. Principal and interest on general long-term obligations are recorded as fund liabilities when due.

***Business – Type Activities – Government – wide financial statements*** account for activities for which a fee is charged to external users for goods or services. In these services, debt may be issued backed solely by these fees and charges. There may be also a legal requirement or a policy decision to recover costs. As such, these funds account for operations similarly to a for – profit business. The Commonwealth’s Institutions of Higher Education’s operations are reported as systems within the proprietary funds. Proprietary fund types are described in more detail below.

***Proprietary and Fiduciary Funds – Fund Financial Statements*** are presented on the same basis of accounting as the business-type activities in the government – wide financial statements.

The Commonwealth reports the following fund types:

**Governmental Fund Types:**

***General Fund***, a governmental fund, is the primary operating fund of the Commonwealth. It is used to account for all governmental transactions, except those required to be accounted for in another fund.

***Special Revenue Funds*** account for specific revenue sources that have been aggregated according to Commonwealth Finance Law to support specific governmental activities.

***Capital Projects Funds*** account for the acquisition or construction of major Commonwealth capital facilities financed primarily from bonds and federal reimbursements.

**Proprietary Fund Types:**

***Unemployment Compensation Fund*** reports the taxes collected from employers and held by the United States Treasury in the Federal Unemployment Trust Fund, from which funds are drawn for the payment of benefits to the unemployed.

***College and University Information*** is presented here, aggregated by the University’s activity, the State Colleges activity and the Community College’s activity.

**Fiduciary Fund Types:**

***Pension Trust Funds*** report resources that are required to be held in trust for the members and beneficiaries of the Commonwealth’s pension plans. These include the State Employees’ and Teachers’ Retirement Systems and assets held in trust for the cities and towns.

***External Investment Trust Funds*** account for the portion of pooled cash and pension assets held under the custodianship of the Commonwealth for the benefit of cities, towns and other political subdivisions of the Commonwealth.

***Private Purpose Funds*** account for various gifts and bequests held by the Commonwealth of which only the income is expendable for purpose specified by the donor. The majority of the individual accounts are for perpetual cemetery care endowments on behalf of deceased individuals. The remaining trust fund in the Massachusetts School Fund, established in 1834 a fund “for the aid and encouragement of common schools.” The fund was originally capitalized from

the proceeds of the 1820's sale of the public lands upon which the State of Maine was created.

**Agency Funds** account for assets the Commonwealth holds on behalf of others. Agency Funds are custodial in nature and do not involve measurement of operations.

Within those fund types, the Commonwealth has established the following funds:

**Highway Fund**, a governmental fund, accounts for user taxes including the gas taxes and fees to finance highway maintenance and safety services.

**Local Aid Fund**, a governmental fund, accounts for the lottery operating surplus and forty percent of income and corporate taxes, thirty-two percent of sales tax and a portion of other taxes which have been earmarked for distribution to municipalities or used to finance programs that benefit local communities and a major portion of the court systems. This fund was repealed effective June 30, 2003 pursuant to Chapter 26, Acts of 2003, Section 128. All future activity will be reported in the General Fund. The fund deficit at the end of FY03 has been transferred to the General Fund.

**Lottery Funds**, governmental funds, account for the operations of the State and Arts Lotteries, which primarily finance payments for local aid.

**Debt Service Fund**, a governmental fund, accounts for the accumulation of resources, principally transfers from other funds, for the payment of long-term debt principal and interest.

**Capital Projects - Central Artery Statewide Roads and Bridges Fund** accounts for the construction of a portion of the Central Artery / Tunnel project financed from FY01 forward, as well as various other statewide road and bridge projects. These expenditures are financed from bond proceeds, certain revenues from Registry of Motor Vehicles fees (net of debt service expenditures) and payments from authorities.

#### *Reporting Standards*

As allowed by GASB statement No. 20, Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting, the Commonwealth's proprietary funds follow all GASB pronouncements and those Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins that were issued on or before November 30, 1989, except those that conflict with a GASB pronouncement.

#### *Fiscal Year Ends*

All funds and discretely presented component units are reported using fiscal years, which end on June 30, except for the Massachusetts Turnpike Authority which utilizes a December 31 year end.

#### *Program and Other Revenue Recognition*

Program revenue is defined by the Commonwealth to be the revenue from fees and assessments collected by departments that are directly applicable to that department's operations. General revenue is derived from taxation, investment

income and other fees that are not allocated to specific programs. In general, taxation revenue is accrued when earned and slated to be received during the next fiscal year. A corresponding receivable is declared, if applicable. Revenues and expenses of business type activities and proprietary funds are classified as operating or nonoperating and are subclassified by object. Operating revenues and expenses generally result from providing services and producing and delivering goods. All other revenues and expenses are reported as nonoperating.

**E. *Cash and Short-Term Investments***

The Commonwealth follows the practice of pooling cash and cash equivalents for some of its Governmental and Fiduciary Funds. Cash equivalents consist of short-term investments with an original maturity of three months or less and are stated at cost or amortized cost, which approximates fair value. Interest earned on pooled cash is allocated to the General Fund and to certain Special Revenue Funds when so directed by law. All Commonwealth, Component Unit, Pension Plan investments are carried at fair value determined by current market rates and quotations.

The Pension Trust Funds, with investments totaling approximately \$26,994,602,000, at fair value, are permitted to make investments in equity securities, fixed income securities, real estate, venture capital funds, real estate funds, limited partnerships, futures pools, international hedge pools, commodities pools, balanced pools, leveraged buyouts, private placements and other alternative investments. For investments traded in an active market, the fair value of the investment will be its market price. The structure, risk profile, return potential and marketability differ from traditional equity and fixed income investments. Concentrations of credit risk exist if a number of companies in which the Pension Trust Fund has invested, are engaged in similar activities and have similar economic characteristics that could cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. To mitigate the exposure to concentrations of risk, the Pension Trust Funds invest in a variety of industries located in diverse geographic areas. As of June 30, 2003, the estimated fair value, determined by management with input from the investment managers, of these real estate and alternative investments was approximately \$4,093,922,000 in the Pension Trust Funds, representing 11.37% of the total assets of the Fiduciary Fund Type.

Pension Trust Fund and External Investment Trust Fund net assets have been restricted as follows:

“Restricted for employee’s pension benefits” identifies resources held in trust for the members and beneficiaries of the Commonwealth’s pension plans.”

“Restricted for external investment trust fund participants” identifies the portion of pooled cash and pension assets held under custodianship of the Commonwealth for the benefit of cities, towns and other political subdivisions of the Commonwealth. The Commonwealth also manages pension assets on behalf of other governments.

The Commonwealth maintains a short-term investment pool. The investments are carried at amortized cost, which approximates fair value. The primary government’s and component unit’s share are reported as short-term investments within their respective reporting categories. The various local governments and other political subdivisions share of net assets is approximately \$2,247,207,000 and is reported as an External Investment Trust within the Fiduciary Fund Type.

Included in the discretely presented Component Units are investments, whose valuation was determined by management. In making its valuations, management considered the cost of investments, current and past operating results, current economic conditions and their effect on the borrowers, estimated realizable values of collateral, and other factors pertinent to the valuation of investments. There is no public market for most of the investments. Management, in making its evaluation, has in many instances relied on financial data and on estimates by management of the companies they have invested in as to the effect of future developments.

Investments of the University of Massachusetts (UMass) are stated at fair value. Annuity contracts represent guaranteed investment contracts and are carried at present value.

**F.     *Securities Lending Program***

Under the securities lending programs, PRIT receives fees for allowing its lending agents to borrow from PRIT's public market equity and fixed income securities, respectively, for a predetermined period of time. These loans are secured with collateral (U.S. Treasury securities), typically equaling 102% of the market value of the domestic securities borrowed and 105% on borrowings of international securities. Pursuant to the Operations Support Agreements with PRIT's lending agents, Mellon Trust held all collateral for securities on loan at June 30, 2003. The collateral securities cannot be pledged or sold by PRIT unless the lending agent(s) default. The lending agents are required to indemnify PRIT in the event that they fail to return the securities on loan (and if the collateral is inadequate to replace the securities on loan) or if the lending agents fail to perform their obligations as stipulated in the agreements.

At June 30, 2003, the market value of the securities on loan was \$2,000,097,000 and the value of the collateral including accrued interest, amounted to approximately \$2,064,954,000, of which \$408,000,000 was held in cash. As of June 30, 2003, securities on loan are included in investments at fair value in the accompanying Statement of Net Assets of Fiduciary Funds.

**G.     *Receivables***

In general, tax revenue is recognized on the government-wide statements, when assessed or levied and on the governmental financial statements to the extent that it is both measurable and available. Receivables are stated net of estimated allowances for uncollectible accounts.

**H.     *Due From Cities and Towns***

Reimbursements due to the Commonwealth for its expenditures on federally funded reimbursement and grant programs are reported as "Federal grants and reimbursements" or "Due from federal government."

These amounts represent reimbursement due to the Commonwealth for its expenditures on certain programs for the benefit of cities and towns.

**I.     *Fixed Assets***

Capital assets, which include property, plant, equipment and infrastructure (e.g. roads, bridges, ramps and other similar items), are reported in the applicable governmental or business-type activity columns of the government-wide financial statements.

*Methods used to value capital assets*

Capital assets are recorded at historical cost or estimated historical cost if purchased or constructed. Donated capital assets are recorded at fair market value at the date of donation.

*Capitalization Policies*

All land, non-depreciable land improvements and donated historical treasures or works of art are capitalized, regardless of cost. Singular pieces of equipment, vehicles, computer equipment and software that equal or exceed \$50,000 (\$1,000 for the University of Massachusetts) are capitalized. Buildings and infrastructure projects with a cost that equals or exceeds \$100,000 are capitalized. The costs of normal maintenance and repairs that do not add to the value of assets or materially extend asset lives are not capitalized.

*Depreciation and useful lives*

Applicable capital assets are depreciated using the straight-line method with a full year's depreciation charged in the year of acquisition but not in the year of disposal, regardless of date. Estimated useful lives are as follows:

<i>Type of Asset</i>	<b>Estimated Useful Life (in years)</b>
Buildings .....	40
Infrastructure - roads, bridges and tunnels .....	40
Infrastructure - beaches, boardwalks, bikeways, etc. ....	25
Infrastructure - dams, water and sewer systems .....	50
Furniture .....	10
Library collections that are not historical treasures .....	15
Equipment, office equipment and life safety equipment .....	10
Computer hardware and software .....	3 to 7
Vehicles .....	5

*Construction in Process*

Construction in process includes all associated cumulative costs of a constructed fixed asset. Construction in process is relieved at the point at which an asset is placed in service for its intended use. For the Central Artery / Tunnel Project, construction in process is relieved upon agreement between the Massachusetts Highway Department, the MTA and / or the Massachusetts Port Authority, its engineers and respective boards. The chief engineer of the Highway Department, or their designees, jointly determine and certify to the MTA or the Massachusetts Port Authority that the respective authorities can safely open each such facility or segment thereof to vehicular traffic or that such facility can safely be used for its intended purpose. As of June, 30 2003, approximately \$2,088,428,000 of project costs has been transferred to the various authorities, including \$10,252,000 of costs transferred outside of the current agreements to the Massachusetts Port Authority, out of the \$12,728,735,000 CA / T expended costs.

Fixed assets of the Component Units are capitalized upon purchase and depreciated on a straight-line basis over the estimated useful lives of the assets. Interest incurred during construction is capitalized.

**J.      *Interfund/Intrafund  
Transactions***

As a general rule, the effect of interfund activity has been eliminated in the government-wide statements. Exceptions to this rule are: 1) activities between funds reported as governmental activities and funds reported as business-type activities and 2) activities between funds that are reported in different functional categories in either the governmental or business-type activities column. Elimination of these activities would distort the direct costs and program revenues for the functions concerned.

Interfund receivables and payables have been eliminated from the Statement of Net Assets, except for the residual amounts due between governmental and business-type activities.

**K.     *Statewide Cost  
Allocation Plan –  
Fringe Benefit Cost  
Recovery***

Certain costs of nine “central service” agencies of the Commonwealth are recovered from the remaining agencies in a federally approved statewide cost allocation plan. These costs that are allocated are based upon benefits received by the user agency that benefits from these services. The Commonwealth also appropriates and pays the fringe benefit costs of its employees and retirees through the General Fund. These fringe benefits include the costs of employees’ group health insurance, pensions, unemployment compensation and other costs necessary to support the workforce. As directed by Massachusetts General Laws, these costs are assessed to other funds based on payroll costs, net of credits for direct payments. Since fringe benefit costs are not separately appropriated or otherwise provided for in these funds, the required assessment creates an unfavorable budget variance in the budgeted funds. The employees’ group health insurance and worker’s compensation activity is accounted for in the governmental funds. The Commonwealth has elected not to present its cost allocation and recovery separately in the Statement of Activities.

**L.     *School Construction  
Grants and Contract  
Assistance Payable***

The Commonwealth, through legislation, is committed to reimburse certain cities, towns and regional school districts for a portion of their debt service costs for school construction and renovation. This amount is recorded as long-term liability in the statement of net assets. The amount to be paid during the next fiscal year is reported as current. For the governmental fund financial statements, the amounts expected to be liquidated with available financial resources are reported as expenditures and fund liabilities. The liability for school construction grants payable is the present value of the cash flows due to municipalities for the life of the program for existing commitments, discounted at the incremental borrowing rate of the Commonwealth, approximated by the Treasurer and Receiver- General for the fiscal year. During FY03, the weighted average discount rate was approximately 4.7%.

The Commonwealth recognizes contract assistance due to MCCA, R3N, MWPAT and MassDevelopment as long-term liabilities on the statement of net assets. These liabilities equate to portions or the whole of certain debt service of these entities. In addition, a payable is declared to the MTA as a cash flow reimbursement for the operations and maintenance of the Central Artery / Tunnel Project.

**M.     *Compensated  
Absences***

Compensated absences are recorded as a long-term liability in the statement of net assets. Amounts to be paid during the next fiscal year are reported as current. For the governmental fund statements, accumulated vacation and sick leave expected to be liquidated with expendable available financial resources, defined as tax revenues earned but received during the next fiscal year, are reported as expenditures and fund liabilities.

Employees are granted vacation and sick leave in varying amounts based on collective bargaining agreements and state laws. Upon retirement, termination or death, certain employees are compensated for unused vacation and sick leave (subject to certain limitations) at their current rate of pay.

In the business type activity and the discretely presented component units, employees' accumulated vacation and sick leave are recorded as an expense and liability as the benefits accrue.

**N. Long Term Obligations**

Long-term obligations consist of unmatured long term debt obligations, amounts due to discretely presented component units and related organizations connected with the Central Artery / Tunnel Project, school construction grants and contract assistance payable to component units and other liabilities including capital lease obligations and the net pension obligation of the Commonwealth (representing the actuarially derived pension cost in excess of actual contributions made).

**O. Lottery Revenue and Prizes**

Ticket revenues and prizes awarded by the Massachusetts Lottery Commission are recognized as drawings are held. For certain prizes payable in installments, the Commonwealth purchases annuities and principal-only and interest-only treasury strips in the Commonwealth's name, which are recorded as annuity contracts and prizes payable in Agency Funds. Though the annuities are in the Commonwealth's name in the case of a default, they are solely for the benefit of the prizewinner. The Commonwealth retains the risk related to such annuities.

**P. Risk Financing**

The Commonwealth does not insure for employees workers' compensation, casualty, theft, tort claims and other losses. Such losses, including estimates of amounts incurred but not reported, are included as accrued liabilities in the accompanying financial statements when the loss is incurred. For employee's workers' compensation, the Commonwealth assumes the full risk of claims filed under a program managed by the Human Resources Division. For personal injury or property damages, Massachusetts General Laws limit the risk assumed by the Commonwealth to \$100,000 per occurrence, in most circumstances. The Group Insurance Commission administers health care and other insurance for the Commonwealth's employees and retirees.

**Q. Net Assets**

The Commonwealth reports net assets as reserved where legally segregated for a specific future use. Otherwise, these balances are considered unrestricted.

Net Assets have been restricted as follows:

"Restricted for unemployment benefits" – identifies amounts solely for payment of unemployment compensation.

"Restricted for retirement of indebtedness" – identifies amounts held by fiscal agents to fund future debt service obligations pertaining to Special Obligation Revenue Bonds authorized under Section 20 of Chapter 29 of the Massachusetts General Laws and Chapter 33, Acts of 1991. It also includes amounts held for Grant Anticipation Notes authorized by Chapter 11 of the Acts of 1997 and Chapter 121 of the Acts of 1998.

"Restricted for central artery workers' compensation and general liability" – identifies amounts held to pay future workers' compensation and general liability claims through the Central Artery / Tunnel Project's owner controlled insurance program.

"Restricted for other purposes" – identifies amounts held for various externally imposed restrictions either by creditors, grantors or laws and regulations of other governments. It also includes various restrictions put forth by the

Commonwealth through constitutional or enabling statutes. Included in this restriction are reserves for stabilization and prior appropriations continued.

**R.      *Reclassifications***

For FY03, certain reclassifications have been made to the FY02 balances to conform to the presentation in FY03. Certain amounts in the separately issued Component Units financial statements have been reclassified to conform to the accounting classifications used by the Commonwealth. Due to the provisions of GASB Statement 34 (“GASB 34”) “*Basic Financial Statements – and Management’s Discussion and Analysis – For State and Local Governments*”, major governmental and proprietary funds presented in a previous year may not be major funds presented in the current year.

**S.      *New Accounting Standards***

During FY03, the Commonwealth implemented the following new accounting standards issued by the GASB:

Technical Bulletin No. 2003 – 1 “*Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets*” supersedes Technical Bulletin 94-1, and clarifies guidance on derivatives disclosures, pending the results of the GASB’s ongoing project on reporting and measurement of derivatives and hedging activities. This bulletin applies an updated definition of derivatives and changes disclosure requirements for derivatives (mainly swaps associated with variable rate debt).

GASB Statement No. 41 “*Budgetary Comparison Schedules – Perspective Differences*” amends GASB 34’s, required supplemental information disclosure of adopted budget and actual amounts. Should there be a perspective difference between these amounts and fund perspective revenues and expenditures, reconciliation is required.

For FY04, the Commonwealth will be implementing the following:

Statement No. 39 “*Determining Whether Certain Organizations Are Component Units*” amends Statement No. 14, “*The Financial Reporting Entity*.”

For FY05, the Commonwealth will be implementing the following:

Statement No. 40 “*Deposit and Investment Risk Disclosures*,” amends Statement No. 3 “*Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*”.

As of the date of the opinion, the Commonwealth has not evaluated the financial impact of GASB Statements 39 and 40.

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## 2. BUDGETARY CONTROL

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State finance law requires that a balanced budget be approved by the Governor and the Legislature. The Governor presents an annual budget to the Legislature which includes estimates of revenues and other financing sources and recommended expenditures and other financing uses. The Legislature, which has full authority to amend the budget, adopts an expenditure budget by appropriating monies at the individual appropriation account level in an annual appropriations act.

Before signing the appropriations act, the Governor may veto or reduce any specific item, subject to legislative override. Further changes to the budget established in the annual appropriations act may be made via supplemental appropriations acts or other legislative acts. These must also be signed by the Governor and are subject to the line item veto.

In addition, Massachusetts General Laws authorize the Secretary of Administration and Finance, with the approval of the Governor, upon determination that available revenues will be insufficient to meet authorized expenditures, to withhold allotments of appropriated funds which effectively reduce the account's expenditure budget.

The majority of the Commonwealth's appropriations are non-continuing accounts which lapse at the end of each fiscal year. Others are continuing accounts for which the Legislature has authorized that an unspent balance from the prior year be carried forward and made available for spending in the current fiscal year. In addition, the Legislature may direct that certain revenues be retained and made available for spending within an appropriation. Fringe benefits and other costs which are mandated by state finance law are not itemized in the appropriation process and are not separately budgeted.

Because revenue budgets are not updated subsequent to the original appropriation act, the comparison of the initial revenue budget to the subsequent, and often modified, expenditure budget can be misleading. Also, these financial statements portray fund accounting with gross inflows and outflows, thus creating a discrepancy to separately published budget documents. In conducting the budget process, the Commonwealth excludes those interfund transactions that by their nature have no impact on the combined fund balance of the budgeted funds.

Generally, expenditures may not exceed the level of spending authorized for an appropriation account. However, the Commonwealth is statutorily required to pay debt service, regardless of whether such amounts are appropriated.

During FY03, the Commonwealth experienced a continued downturn in certain budgeted revenues. The revenue estimates, under the provisions of section 5D of Chapter 29 of the General Laws, were determined to be insufficient to meet all of the expenditures authorized for FY03. Therefore, in accordance with section 9C of said Chapter 29, the Secretary for Administration and Finance notified the Governor and the House and Senate Committees on Ways and

Means of the amount of the probable deficiency of revenue. In accordance with the Governor's authority under said section 9C, the Governor reduced allotments under section 9B of said Chapter 29. The amount of this reduction was proposed to be \$419,934,000. However, the Legislature enacted Section 74 of Chapter 4 of the Acts of 2003, which directed the Comptroller to transfer the amount of reductions proposed to the General Fund that would not cause a fund to go into deficit. The amount so transferred was \$73,914,000. Furthermore, the FY04 General Appropriation Act (Chapter 26, Section 167 of the Acts of 2003), amended section 9C, directing the Governor to notify the Legislature in writing as to the reasons for and the effect of any reductions. Alternatively, the Governor may propose specific additional revenues to equal the deficiency. The Governor may also propose to transfer funds from the Stabilization Fund to cure such deficiency. This proposal must be delivered to the Legislature 15 days before any reductions take effect.

The following table summarizes budgetary activity for all budgeted funds for FY03 (amounts in thousands):

	Revenues	Expenditures
General Appropriation Act, Chapter 184 of the Acts of 2002:		
Direct appropriations.....	\$ 21,685,399	\$ 21,684,096
Estimated revenues, transfers, direct appropriations retained revenue appropriations, interagency chargebacks and appropriations carried forward from FY2002 .....	1,312,749	1,312,749
Total Original Budget.....	22,998,148	22,996,845
Supplemental Acts of 2002:		
Chapter 300 .....	-	2,781
Chapter 429.....	-	300
Supplemental Acts of 2003:		
Chapter 4.....	-	8,463
Chapter 6.....	-	62,338
Chapter 12.....	-	2,000
Total Before June 30, 2003 .....	22,998,148	23,072,727
Supplemental Acts of 2003, passed after June 30, but for FY03:		
Chapter 55 .....	-	25,138
Total Budgeted Revenues and Expenditures per Legislative Action .....	22,998,148	23,097,865
Plus: Transfers of Revenues and Expenditures (including rounding).....	-	1,088,092
Budgeted Revenues and Expenditures as Reported.....	<u>\$ 22,998,148</u>	<u>\$ 24,185,957</u>

### 3. DEPOSITS AND INVESTMENTS

**Cash and Short-term Investments** –The Commonwealth maintains a cash and short-term investment pool, which is utilized by the Governmental and Fiduciary Fund types.

#### **Primary Government -**

As of June 30, 2003, the carrying amount of the Primary Government's total cash and cash equivalents was approximately \$1,143,982,000 and the corresponding bank balance was approximately \$775,024,000. Bank deposits in the amount of approximately \$9,030,000 were insured by the Federal Deposit Insurance Corporation and approximately \$112,253,000 were collateralized in the name of the Commonwealth and are held by various financial institutions. Deposits of approximately \$653,741,000 were uninsured and uncollateralized.

**Component Units -**

As of June 30, 2003, the carrying amount of the discretely presented component units' total cash and cash equivalents was approximately \$818,941,000 and the corresponding bank balances were approximately \$683,820,000. Bank deposits of approximately \$155,340,000 were insured by the Federal Deposit Insurance Corporation, approximately \$77,291,000 were collateralized in the name of the respective component units, and approximately \$451,189,000 were uninsured and uncollateralized.

**Investments** – The investments are reported at fair value in the financial statements. The deposits and investments of the Component Units and the University and College Funds and the investments of the Pension Trust Funds are held separately from those of other Commonwealth funds, with the exception of their investments in MMDT. Statutes authorize the Primary Government to invest in obligations of the U.S. Treasury, authorized bonds of all states, bankers' acceptances, certificates of deposit, commercial paper rated within the three highest classifications established by Standard & Poor's Corporation and Moody's Commercial Paper Record and repurchase agreements secured by any of these obligations. The Pension Trust Funds are permitted to make investments in equity securities, fixed income securities, real estate and other alternative investments. In the following table, these alternative investments, venture capital and futures pools are classified as other investments.

Short-term investments and investments are classified as to collateral risk into the following three categories:

Category 1: Insured or registered, or securities held by the Commonwealth or its agent in the Commonwealth's name.

Category 2: Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the Commonwealth's name.

Category 3: Uninsured and unregistered, with securities held by the counterparty, or by its trust department or agent but not in the Commonwealth's name.

**Primary Government** – Investments of the Government at June 30, 2003, were as follows (amounts in thousands):

	Category 1	Category 2	Category 3	Total
<u>Investment</u>				
Repurchase agreements.....	\$ 570,192	\$ -	\$ -	\$ 570,192
U.S. Treasury obligations.....	175	7,734	-	7,909
Commercial paper.....	3,162,950	1	-	3,162,951
Government obligations.....	3,270,460	35,308	-	3,305,768
Equity securities.....	16,744,354	817	10,078	16,755,249
Fixed income securities.....	4,985,695	1,981	12,691	5,000,367
Asset backed investments.....	365	-	-	365
Notes.....	60,486	-	-	60,486
Other.....	4,353	6,419	9,470	20,242
	<u>\$ 28,799,030</u>	<u>\$ 52,260</u>	<u>\$ 32,239</u>	28,883,529
Money Market investments.....				1,185,191
Mutual fund investments.....				67,639
Annuity contracts.....				1,398,339
Real estate.....				1,906,553
Assets held in trust.....				2,561,884
Deposits with U. S. Treasury.....				490,652
Negotiable Certificates of Deposits.....				180,397
Other.....				3,274,707
Total.....				<u>\$39,948,891</u>

***A. Financial Investments  
with Off-Balance Sheet  
Risk***

Certain investments of the Commonwealth may involve a degree of risk not accounted for on the respective financial statements. A description of such “off-balance sheet risks” is as follows.

*Foreign Currency Exchange Contracts*

Within the Pension Trust Funds, PRIT enters into forward currency contracts to hedge the exposure to changes in foreign currency exchange rates on foreign portfolio holdings. The market value of the contract will fluctuate with changes in currency exchange rates.

The contract is marked-to-market daily and the change in market value is recorded by the fund as an unrealized gain or loss by the Pension Trust Fund.

When the contract is closed, the Pension Trust Funds record a realized gain or loss equal to the difference between the value of the contract at the time it was opened and the value at the time it was closed. The maximum potential loss from such contract is the aggregate face value in U.S. dollars at the time the contract was opened.

*Futures Contracts*

Within the Pension Trust Funds, PRIT may purchase and sell financial futures contracts to hedge against changes in the values of securities the fund owes or expects to purchase. Upon entering such contracts, they must pledge to the broker an amount of cash or securities equal to the minimum “initial margin” requirements of the futures.

The potential risk is that the change in the value of futures contracts primarily corresponds with the value of underlying instruments, which may not correspond to the change in value of the hedged instruments. In addition, there is a risk that PRIT may not be able to close out its futures positions due to a nonliquid secondary market. Risks may arise from the potential inability of a counterparty to meet the terms of a contract and from unanticipated movements in the value of a foreign currency relative to the U.S. dollar. The Pension Trust Funds may also invest in financial futures contracts for nonhedging purposes.

Payments are made or received by the Pension Trust Funds each day, depending on the daily fluctuations in the value of the underlying security, and are recorded as unrealized gains or losses. When the contracts are closed, the Pension Trust Funds recognize a gain or loss.

*Forward Purchase Agreement*

During FY02, the Commonwealth entered into a forward purchase agreement with two investment providers to receive investment earnings on grant draws for the payment of the Commonwealth’s Grant Anticipation Notes (GANs) principal and interest for the period from June 19, 2002 to July 15, 2014 for note payments approximately six to eleven months after these grant draws. The value of this contract to the Commonwealth was satisfied at closing with a payment to the Commonwealth of \$76,435,000 during FY02. Such amounts were presented as an inflow to the Highway Fund and revenue to the Commonwealth. The agreements may only be terminated in the event of a defeasance or refunding of the GANs by the Commonwealth. Should termination occur, the Commonwealth may be liable for a termination amount to

be agreed upon between the Commonwealth and the providers at the termination date.

### *Options*

PRIT is also engaged in selling or “writing” options. The Pension Trust Funds, as writers of options, may have no control over whether the underlying securities may be sold (call) or purchased (put) and, as a result, bear the market risk of an unfavorable change in the price of the security underlying the written option. As of June 30, 2003, there were no material options outstanding.

### *Swap Agreements at PRIT and HST*

During FY03, PRIT’s Core Realty Holdings LLC (a limited liability company inclusive of PRIT and HST – “LLC,”) entered into eight interest rate swap contracts for the purpose of hedging its floating – rate interest exposure. PRIT holds 99.41% of the LLC while HST holds the remaining 0.59%. The swap contracts are reported at fair value, which represents their estimated liquidation values (costs) to the LLC. The LLC either receives cash from the swap counterparties or pays the swap counterparties monthly depending on whether the fixed-rate interest is lower or higher than the variable – rate interest. Changes in the fair value of the swap contracts are included in net change in unrealized appreciation on investments and foreign currency transactions, and the income or expense related to settlements of interest under the contracts are included in real estate income, net in PRIT and HST’s financial statements.

As of June 30, 2003, the LLC had the following swap contracts in effect (amounts in thousands):

<u>Counterparty</u>	<u>Fixed Rate Paid</u>	<u>Notional Amount</u>	<u>Effective Date</u>	<u>Maturity Date</u>	<u>Fair-Value</u>
Fleet National Bank.....	4.82%	\$ 50,000	7/23/2002	7/1/2012	\$ (5,830)
Citibank, N. A. New York.....	4.32%	50,000	8/5/2002	8/1/2009	(4,522)
Bear Stearns Bank PLC.....	3.95%	50,000	8/19/2002	9/1/2007	(3,679)
Fleet National Bank.....	4.18%	50,000	12/2/2002	12/3/2012	(3,072)
Citibank, N. A. New York.....	3.68%	50,000	1/1/2003	1/1/2010	(2,458)
Mellon Bank.....	3.17%	50,000	1/30/2003	2/1/2008	(1,915)
Mellon Bank.....	3.82%	50,000	3/6/2003	6/1/2013	(1,316)
Bear Stearns Bank PLC.....	3.45%	50,000	5/13/2003	6/1/2011	(933)
		<u>\$400,000</u>			<u>\$ (23,725)</u>

To determine the fair values of its swap agreements, the LLC uses methods and assumptions considering market conditions and risks existing at the date of PRIT’s financial statements. Such methods and assumptions incorporate standard valuation conventions and techniques such as discounted cash flow analysis and option pricing models. All methods utilized to estimate fair values result in only general approximations of value, and such values may or may not actually be realized. Fair value estimates are closely correlated with changes in market interest rates and the passage of time. For example, rising market interest rates will generally increase the swaps’ termination values to the LLC, whereas termination values are generally reduced as the swaps approach their maturity dates and fewer interest settlements remain under the contracts. As of June 30, 2003, neither the LLC, nor its counterparties expressed intentions to terminate its swap agreements prior to their scheduled maturity dates.

**B. Discretely Presented  
Component Unit  
Investments**

Investments of the discretely presented Component Units at June 30, 2003 are as follows (amounts in thousands):

	Category 1	Category 2	Category 3	Total
<u>Investment</u>				
Repurchase agreements.....	\$ 42,561	\$ 361,570	\$ 3,058	\$ 407,189
U.S. Treasury obligations.....	-	-	-	-
Commercial paper.....	215,224	-	-	215,224
Government obligations.....	848,265	245,253	2,100	1,095,618
Equity securities.....	2,575	3,232	3,910	9,717
Fixed income securities.....	39,308	-	-	39,308
Notes.....	4,517	-	5,138	9,655
Other.....	-	51	4,611	4,662
	<u>\$1,152,450</u>	<u>\$ 610,106</u>	<u>\$ 18,817</u>	<u>1,781,373</u>
Mutual Fund Investments.....				189,906
Assets held in trust.....				302
Guaranteed investment contracts.....				1,171,121
Negotiable Certificate of deposits.....				18,059
Total.....				<u>\$ 3,160,761</u>

*Component Unit Swap Agreement Investments*

In FY99, the MTA entered into an interest rate swap option agreement with Morgan Guaranty Trust Company of New York (MGTC). This “Swaption” agreement runs through July 1, 2029 and carries a notional amount of \$100 million. The MTA received a premium payment in FY00 of \$5.4 million as part of the agreement. This premium was recorded by the MBTA as a deferred credit and is being recongnized as an adjustment of interest expense over the 30-year life of the agreement. MGTC had the right, but not the obligation, to exercise the swap option on January 1, April 1, July 1 and October 1 of any year from July 1, 2002 to July 1, 2029. MGTC had the right to enter the MTA into the swap when the average Bond Market Association Municipal Swap Index (BMA) / London Interbank Offered Rate (LIBOR) ratio exceeds 72% over 12 consecutive months beginning April 1, 2002. The MTA’s payment obligation would be equal to the difference between the BMA and 67% of LIBOR, multiplied by the \$100 million. Conversely, the Authority may receive payments under this agreement when 67% of LIBOR exceeds the BMA. MGTC exercised its option on October 1, 2002 and the MTA received \$56,000 of interest in January 2003. The MTA may be exposed to certain risks related to this transaction should the counterparty default.

The MBTA has also entered into various agreements in order to provide the MBTA with a stable and predictable cost of fuel. These agreements create a synthetic fixed rate for the purchase of fuel for fixed periods of time rather than being exposed to unpredictable variations of fuel prices on the spot market. Prices are sourced through PLATT’s Oilgram Price Report. The hedge agreements are summarized as follows (amount in thousands):

Commodity Type	Price Per Gallon	Initial Notional Amount Gallons	Trade Date	Termination Date	Counterparty (ratings - Moody's / S&P)
Bus Fuel - LS Jet Kero.....	\$0.6775	12,200	10/29/2001	7/31/2003	Aal / AA
Rail Fuel - New York Harbor No. 2.....	0.6390	13,140	10/29/2001	6/30/2003	Aal / AA
Bus Fuel - Jet Fuel.....	0.7925	3,945	9/12/2003	6/30/2004	Aal / AA
Rail Fuel - Heating Oil.....	0.7500	6,318	9/12/2003	6/30/2004	Aal / AA

The MBTA is exposed to basis risk on its fuel swaps, where the fuel price index used on the swaps may not fully offset the actual cost of the MBTA's fuel purchases.

The MBTA also has an "asset-side" swaption for a reserve investment. This swaption was executed in FY01 and has a notional amount of \$49,123,000. The MBTA received a lump – sum payment on the swaption of \$1,265,000 in FY02. The counterparty may execute its option annually on January 1 and July 1 from 2010 through 2030. The agreement has a fixed payable rate of 5.6% and a variable receivable rate at BMA. The counterparty has a Aa2 / Aa+ credit rating as of June 30, 2003. The agreement's fair value as of June 30, 2003 was a negative (\$2,185,000.)

In FY01, the MTA entered into five interest rate swap options with UBS AG, the Parent Company of UBSPaine Webber (UBS). These swaptions grant UBS the right to enter a swap with the MTA in which UBS would pay a floating rate and receive a fixed rate from the MTA. The swaption exercise dates and fixed rates due from the MTA are designed to match the call provisions and rates of certain of the MTA's bonds. If UBS exercises its option, the MTA expects to refund certain of its fixed rate bonds with floating rate bonds. The floating rate received by the MBTA under the swap would provide a hedge for the floating rate due on its refunding bonds. In turn, the MTA's payments to UBS would match the payments expected to be made to fixed rate bondholders. UBS paid \$6.2 million on behalf of the MTA during FY01 to purchase insurance for the payments that the MTA may be required to make under the swaps, if exercised. This amount was recorded in the MTA's financial statements as prepaid insurance and is amortized over the life of the swap, which is 35 years.

As of December 31, 2002 the Authority had recorded a long-term receivable of \$16.4 million. A corresponding deferred credit totaling \$29.1 million was recorded during FY02 related to this transaction. This amount is being amortized over the life of the swap, which is 35 years. The balance at December 31, 2002 was \$28.3 million. The MTA may be exposed to certain risks related to this transaction should the counterparty default.

In FY03, the MTA entered into five interest rate swap option agreements with Lehman Brothers Special Financing Inc. (Lehman). These Swaptions grant Lehman the right to enter a swap with the MTA in which Lehman would pay the MTA a fixed rate of 5% and the MTA would pay Lehman a floating rate of BMA. As a fixed – to – floating swap, the transaction was designed to "offset" the FY01 UBS swaption and, as a result, has the effect of mitigating certain risks inherent in that transaction if both are executed. Lehman paid \$6.4 million to the MTA during FY03 and will pay an additional \$28.8 million in subsequent years. This amount was recorded in the MTA's financial statements as a deferred credit and will be amortized over the life of the swap, which is 35 years.

A corresponding deferred credit totaling \$35.2 million was recorded during FY03 related to this transaction. This amount is being amortized over the life of the swap, which is 35 years. The MTA may be exposed to certain risks related to this transaction should the counterparty default.

In order to mitigate potential future market risks associated with the UBS and Lehman swaption agreements, the MTA set aside \$12.5 million in cash and investments in FY02.

Receivable amounts recorded by the MTA under these agreements are as follows (amount in thousands):

Due January 1,	UBS Amounts	Lehman Amounts
2003.....	\$ 3,280	\$ 5,416
2004.....	3,281	5,849
2005.....	3,281	5,849
2006.....	3,281	5,849
2007.....	3,281	5,848
2008.....	3,281	-
	<u>19,685</u>	<u>28,811</u>
Less: Current Portion.....	<u>(3,280)</u>	<u>(5,416)</u>
	<u>\$ 16,405</u>	<u>\$ 23,395</u>

#### 4. RECEIVABLES

Taxes, federal reimbursements, loans and other receivables are presented in the statement of net assets as follows (amounts in thousands):

<i>Primary Government</i>	Taxes Receivable	Federal Grants and Reimbursements	Loans	Other Receivables	Total
Governmental receivables .....	\$ 2,061,653	\$ 1,229,208	\$ -	\$ 811,839	\$ 4,102,700
Business-type activity receivables.....	-	37,476	53,354	581,904	672,734
Less: allowance for uncollectibles.....	<u>(311,671)</u>	<u>(7,023)</u>	<u>(7,257)</u>	<u>(757,415)</u>	<u>(1,083,366)</u>
Receivables, net of allowance for uncollectibles .....	1,749,982	1,259,661	46,097	636,328	3,692,068
Less: Current Portion:					
Governmental activities .....	(1,749,982)	(1,222,185)	-	(233,252)	(3,205,419)
Business-type activities .....	<u>-</u>	<u>(37,476)</u>	<u>(29,936)</u>	<u>(351,297)</u>	<u>(418,709)</u>
Noncurrent receivables .....	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 16,161</u>	<u>\$ 51,779</u>	<u>\$ 67,940</u>

<i>Discretely Presented Component Units</i>	Taxes Receivable	Federal Grants and Reimbursements	Loans	Other Receivables	Total
Massachusetts Bay Transportation Authority .....	\$ -	\$ 12,699	\$ -	\$ 27,806	\$ 40,505
Massachusetts Turnpike Authority.....	-	-	-	71,358	71,358
Massachusetts Water Pollution Abatement Trust .....	-	76,563	2,086,334	54,072	2,216,969
Nonmajor Component Units .....	-	28,470	269,403	37,060	334,933
Less: allowance for uncollectibles.....	<u>-</u>	<u>-</u>	<u>(17,136)</u>	<u>-</u>	<u>(17,136)</u>
Receivables, net of allowance for uncollectibles .....	-	117,732	2,338,601	190,296	2,646,629
Less: Current Portion .....	<u>-</u>	<u>(117,732)</u>	<u>(148,467)</u>	<u>(145,876)</u>	<u>(412,075)</u>
Noncurrent receivables .....	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,190,134</u>	<u>\$ 44,420</u>	<u>\$ 2,234,554</u>

## 5. RECEIVABLES AND PAYABLES BETWEEN FUNDS

Receivables and payables between funds reflected as due to/from primary government in the combined balance sheet at June 30, 2003 are summarized as follows (amounts in thousands):

### *Primary Government*

Due to / from other funds:

<u>Receivable Fund</u>	<u>Payable Fund</u>	<u>Amount</u>
<u>Governmental Funds</u>		
General Fund	Highway Fund .....	\$ 600,512
	Nonmajor Governmental Funds.....	311,929
	Proprietary Funds - University of Massachusetts.....	3,778
Highway Fund	Nonmajor Governmental Funds.....	5
Central Artery Statewide Road and Bridge Fund	General Fund .....	981,862
Nonmajor Governmental Funds	General Fund .....	139,159
Nonmajor Governmental Funds	Nonmajor Governmental Funds ....	<u>83,617</u>
<b>Total Primary Government .....</b>		<b>\$ <u>2,120,862</u></b>

The Commonwealth is currently engaged in the most expensive public construction project in the history of the United States, the Central Artery / Tunnel Project (CA/T or Project). The project will depress the Central Artery (Interstate 93) through downtown Boston and connect the Massachusetts Turnpike (Interstate 90) through a tunnel under Boston Harbor directly to Logan International Airport. In addition to Commonwealth debt and funds from the Federal Government, the MTA (a component unit) and Massport (a related organization) have contributed to the costs of construction. Once completed the assets of the project will be transferred to these entities for operations and maintenance.

All contributions to the Central Artery / Tunnel Project from component units are reflected as additions to construction in process on the various component units' financial statements, pursuant to Massachusetts General Laws, Chapter 81A. The Commonwealth reflects these payments as transfers from component units.

As part of the Commonwealth's implementation of GASB 34, the Commonwealth has recorded the Commonwealth's construction cost to date for the Central Artery / Tunnel Project, net of amounts transferred to the MTA and Massport. This amount is reflected as "Construction in Process – Central Artery / Tunnel Project". This construction in process amount is offset by two corresponding liabilities: "Due to Component Units – Central Artery / Tunnel Project" for the MTA's portion and "Due to Other Related Organizations" for Massport's portion. As portions of the project are completed and transferred to either the Turnpike Authority or Massport in accordance with Massachusetts General Laws, Chapter 81A (MGL 81A) (upon agreement of the various engineers and the Authorities' Boards of Directors), these amounts will be reduced for the value of the assets transferred.

The MTA presents its audited financial statements on a calendar year basis for the year ended December 31, 2002. The following summarizes the activity for CA / T for FY2003 (amounts in thousands):

**Total Project budget as of June 30, 2003 ..... \$ 14,625,000**

**I. Determination of MTA amounts:**

Cumulative Authorized Project Invoices as of June 30, 2003 ..... \$ 12,728,735  
 Less: Amounts to be transferred to Massport as of December 31, 2002 ..... (365,000)  
 Less: Amounts transferred previous to December 31, 2002 to the Turnpike Authority ..... (2,078,176)

**Subtotal - Due to Component Units - Central Artery / Tunnel Project as of June 30, 2003 ..... 10,285,559**  
 Less: Construction Expenses January 1 to June 30, 2003 ..... (499,349)  
 Amounts recognized as contributed by the MTA as of December 31, 2002 ..... (1,555,000)

Amounts not recognized as contributed to the MTA in their financial statements  
 as of December 31, 2002 ..... \$ 8,231,210

**II. Determination of Massport Amounts:**

Massport's Portion of the Central Artery / Tunnel Project as determined  
 under Massachusetts General Laws Chapter 81A ..... \$ 365,000

Amounts recognized as Due to Other Related Organizations ..... \$ (365,000)

Amounts contributed by Massport to the project as of June 30, 2003 ..... **\$ 265,000**

**6. FIXED ASSETS**

Capital asset activities for the fiscal year ended June 30, 2003 are as follows (amounts in thousands):

<i>Primary Government Governmental Activities</i>	July 1, 2002 Beginning Balance	Increases	Decreases	June 30, 2003 Ending Balance
Capital assets not being depreciated:				
Land .....	\$ 643,917	\$ 32,464	\$ 2,019	\$ 674,362
Construction in process - non - Central Artery / Tunnel Project .....	465,797	396,614	132,542	729,869
Construction in process - Central Artery / Tunnel Project .....	9,666,140	1,063,006	78,587	10,650,559
Total capital assets not being depreciated .....	10,775,854	1,492,084	213,148	12,054,790
Capital assets being depreciated:				
Buildings .....	3,455,110	195,392	156,132	3,494,370
Machinery and equipment .....	676,042	57,310	28,170	705,182
Infrastructure.....	10,734,113	104,376	-	10,838,489
Total capital assets being depreciated .....	14,865,265	357,078	184,302	15,038,041
Less, accumulated depreciation:				
Buildings .....	1,667,383	72,045	133,344	1,606,084
Machinery and equipment .....	551,123	58,362	27,718	581,767
Infrastructure.....	3,756,492	265,692	-	4,022,184
Total accumulated depreciation .....	5,974,998	396,099	161,062	6,210,035
Total capital assets being depreciated, net .....	8,890,267	(39,021)	23,240	8,828,006
Governmental activity capital assets, net .....	\$ 19,666,121	\$ 1,453,063	\$ 236,388	\$ 20,882,796
<i>Business - Type Activities</i>				
Capital assets not being depreciated:				
Land .....	\$ 68,185	\$ 4,946	\$ 14,653	\$ 58,478
Construction in process .....	115,740	123,085	84,127	154,698
Historical treasures .....	553	120	1	672
Total capital assets not being depreciated .....	184,478	128,151	98,781	213,848
Capital assets being depreciated:				
Buildings .....	2,115,075	182,559	4,582	2,293,052
Machinery and equipment .....	621,648	68,962	30,543	660,067
Library collections, not including historical treasures .....	128,527	8,462	12,679	124,310
Total capital assets being depreciated .....	2,865,250	259,983	47,804	3,077,429
Less, accumulated depreciation:				
Buildings .....	1,192,922	101,988	2,557	1,292,353
Machinery and Equipment .....	356,618	39,530	5,440	390,708
Library collections, not including historical treasures .....	13,847	5,320	1,397	17,770
Total accumulated depreciation .....	1,563,387	146,838	9,394	1,700,831
Total capital assets being depreciated, net .....	1,301,863	113,145	38,410	1,376,598
Business - type activity capital assets, net .....	\$ 1,486,341	\$ 241,296	\$ 137,191	\$ 1,590,446
Total Primary Government capital assets, net .....	\$ 21,152,462	\$ 1,694,359	\$ 373,579	\$ 22,473,242

Depreciation expense is not charged to particular functions of the primary government. It is charged in the aggregate.

***Discretely Presented Component Units*** – Fixed assets consist of the following at June 30, 2003 (amounts in thousands):

<i>Discretely Presented Component Units</i>	July 1, 2002 Beginning Balance	Increases	Decreases	June 30, 2003 Ending Balance
Capital assets not being depreciated:				
Land .....	\$ 420,732	\$ 89	\$ 6	\$ 420,815
Construction in process .....	2,111,871	786,916	346,515	2,552,272
Total capital assets not being depreciated .....	2,532,603	787,005	346,521	2,973,087
Capital assets being depreciated:				
Buildings .....	7,273,119	316,844	3,105	7,586,858
Machinery and equipment .....	2,053,896	101,928	21,298	2,134,526
Infrastructure .....	1,401,424	5,387	155	1,406,656
Total capital assets being depreciated .....	10,728,439	424,159	24,558	11,128,040
Less, accumulated depreciation .....	3,639,223	331,170	32,476	3,937,917
Total capital assets being depreciated, net .....	7,089,216	92,989	(7,918)	7,190,123
Discretely Presented Component Unit capital assets, net .....	\$ 9,621,819	\$ 879,994	\$ 338,603	\$ 10,163,210

## 7. SHORT-TERM FINANCING AND CREDIT AGREEMENTS

### ***Primary Government -***

Massachusetts General Laws authorize the Treasurer to issue temporary notes in anticipation of revenue or bond financing. When this short-term debt does not meet long-term financing criteria, it is classified as a fund liability. Short-term debt may be issued on either a stand-alone basis or through a commercial paper program maintained by the Commonwealth.

#### **A. General Fund**

The balance of revenue anticipation notes (RANs) outstanding may fluctuate during a fiscal year, but must be reduced to zero at June 30. During FY03, the Commonwealth issued RANs through its commercial paper program on a periodic basis to meet cash flow needs. Up to \$700,000,000 of RANs were issued during the year. All RANs were retired before the end of June 2003.

#### **B. Capital Projects Funds**

The Commonwealth may issue bond anticipation notes (BANs) to temporarily finance its capital projects. BANs may be issued either on a stand-alone basis or through the Commonwealth's commercial paper program.

During FY03 the Commonwealth periodically issued BANs through the commercial paper program, beginning in August 2002. BANs were rolled over and paid down at various times during the fiscal year. At June 30, 2003, \$507,100,000 of BANs were outstanding.

On September 5, 2001, \$350,000,000 of General Obligation BANs were issued to finance costs associated with the development of Convention Centers in Boston, Worcester and Springfield, and to retire a portion of BANs issued prior to the sale. These notes remained outstanding at year-end, but were subsequently retired on September 2, 2003 through the issuance of \$550,000,000 in General Obligation BANs that will mature on January 15, 2004.

On March 28, 2002, \$180,000,000 in General Obligation BANs were also issued to finance costs of the Central Artery / Tunnel Project, in advance of receiving certain contributions from the Massachusetts Port Authority (Massport). These BANs were retired in April, 2003 through the issuance of commercial paper. During June 2003, Massport delivered to the Commonwealth \$104,900,000 in satisfaction of a portion of the terms of the commercial paper BANs. \$75,100,000 remains outstanding as of June 30, 2003. It is expected that these commercial paper BANs will be retired with proceeds from payments from Massport.

### C. Letter-of-Credit Facilities

During FY03, the Commonwealth maintained a letter-of-credit agreement with a bank in order to provide credit and liquidity support for its commercial paper program. The letter of credit was available to secure up to \$200,000,000 of Commonwealth commercial paper plus interest thereon. Advances were available, subject to certain limitations and bearing interest at the bank rate as defined, in anticipation of revenue or bond proceeds repayable by the following June 30, subject to extension in certain circumstances at the Commonwealth's option. No such advances were drawn during the fiscal year ended June 30, 2003. The cost of the facility is approximately 0.15% on both unutilized and utilized amounts, and expires in December 2003.

### D. Line-of-Credit Facilities

During FY03, the Commonwealth maintained line-of-credit facilities to provide liquidity support for commercial paper notes totaling \$800,000,000. The Commonwealth has a total of four line-of-credit facilities to provide such liquidity support, each in the amount of \$200,000,000. These facilities expire in September and December of 2004, and March and September of 2005. The annual cost of these facilities ranges from 0.125% to 0.17%.

The following schedule details short – term financing and credit agreement activity for all funds for the fiscal year (amounts in thousands):

	Beginning Balance July 1, 2002	Issued / Drawn	Redeemed / Repaid	Ending Balance June 30, 2003	Credit Limit June 30, 2003
General Fund:					
Revenue Anticipation Notes.....	\$ -	\$ 700,000	\$ (700,000)	\$ -	\$ -
Letter-of-Credit Agreements.....	-	-	-	-	200,000
Line-of-Credit Agreements.....	-	-	-	-	800,000
Subtotal - General Fund Activity.....	-	700,000	(700,000)	-	1,000,000
Capital Projects Funds:					
Bond Anticipation Notes.....	530,000	432,000	(104,900)	857,100	-
Subtotal - Capital Projects Funds Activity.....	530,000	432,000	(104,900)	857,100	-
Total Short-Term Financing And Credit Agreement Activity.....	\$ 530,000	\$ 1,132,000	\$ (804,900)	\$ 857,100	\$ 1,000,000

### E. Discretely Presented Component Units

The RTA's had \$100,996,000 of short – term notes payable outstanding at June 30, 2003. All the notes mature during FY04 and have interest rates ranging from 1.40% to 3.31%.

The FY03 General Appropriation Act amended the RTAs' enabling statute. After July 1, 2003, bonds and notes issued by the various RTAs are no longer guaranteed by the Commonwealth and are not general obligations of the Commonwealth.

## 8. LONG-TERM OBLIGATIONS

Under the Constitution of the Commonwealth of Massachusetts, the Commonwealth may borrow money (a) for defense, (b) in anticipation of receipts from taxes or other sources, any such loan to be paid out of the revenue of the year in which the loan is made, or (c) by a two-thirds vote of the members of each house of the Legislature present and voting thereon. The Constitution further provides that borrowed money shall not be expended for any other purpose than that for which it was borrowed or for the reduction or discharge of the principal of the loan. In addition, the Commonwealth may give, loan or pledge its credit by a two-thirds vote of the members of each house of the Legislature present and voting thereon, but such credit may not in any manner be given or loaned to or in aid of any individual, or of any private association, or of any corporation which is privately owned or managed.

The Commonwealth has waived its sovereign immunity and consented to be sued on contractual obligations, including bonds and notes issued by it and all claims with respect thereto. However, the property of the Commonwealth is not subject to attachment or levy to pay a judgment, and the satisfaction of any judgment generally requires legislative appropriation. Enforcement of a claim for the payment of principal or interest on bonds and notes of the Commonwealth may also be subject to the provisions of federal or Commonwealth statutes, if any, enacted to extend the time for payment or impose other constraints upon enforcement.

As of June 30, 2003, the Commonwealth had three types of long-term debt outstanding.

### A. *General Obligation Bonds*

General Obligation Bonds are authorized and issued primarily to provide funds for Commonwealth-owned capital projects and local government improvements. They are backed by the full faith and credit of the Commonwealth and paid from the Governmental Funds, in which debt service principal and interest payments are appropriated. Massachusetts General Laws provide for the allocation of bond proceeds to these authorizations in arrears, as expenditures are made, unless the proceeds are allocated at the time of issuance.

#### *College Opportunity Bonds*

Some Commonwealth general obligation debt is issued as College Opportunity Bonds (COBs) as authorized by the Massachusetts General Laws. Such bonds were initially issued in fiscal year 1996, and have been issued in each subsequent fiscal year, including FY03, when approximately \$10,113,000, (including accretion), of such bonds were issued. Outstanding COBs have maturity dates ranging from 2003 through 2023. COBs have an accreting interest component payable at maturity. The annual accretion rate of each COB's maturity is a variable rate equal to the annual change in the Consumer Price Index (CPI) plus 2.0%. Assuming the CPI averages 3.5% during the life of the outstanding COBs the payments due at maturities of the COBs will total approximately \$173,803,323, including accretion. In addition, COBs pay current interest in the amount of 0.5% per year of the initial amount still outstanding. The full faith and credit of the Commonwealth back these bonds. These bonds are sold to fund the Commonwealth's "U. Plan" which is part of a college savings program administered by the Massachusetts Educational Financing Authority. These bonds are privately placed and are structured to meet the needs of investors in this plan.

*County Debt Assumed*

Chapter 38 of the Acts of 1997 and Chapter 300 of the Acts of 1998 abolished governments of several Massachusetts counties on various effective dates. As part of these provisions, the Commonwealth assumed the outstanding debt of Middlesex County on July 1, 1997, of Hampden and Worcester Counties on July 1, 1998, that of Essex County on July 1, 1999 and that of Berkshire County on July 1, 2000. The county debt assumed has become general obligation debt of the Commonwealth. As of June 30, 2003, \$855,000 of these obligations remain outstanding.

*Variable Rate Demand Bonds*

Included in the long-term debt is \$1,542,615,000 of general obligation variable rate demand bonds (VRDBs) maturing from 2007 through 2030 in varying amounts. The redemption schedule for these bonds is included in the bond redemption schedule contained herein. The interest rate on the VRDBs is determined either weekly or daily based on the activity of the Commonwealth's remarketing agents, and interest is paid monthly. On any reset date holders of the VRDBs can require the Commonwealth (acting through its remarketing and tender agents) to repurchase the bonds (a "put"). The remarketing agent is authorized to use its best efforts to resell any repurchased bonds by adjusting the interest rates offered. The Commonwealth pays an annual fee to the remarketing agents equal to 0.05% of the par amount of the bonds.

Under the provisions of stand-by bond-purchase agreements entered into by the Commonwealth with certain commercial banks, the remarketing and tender agents are entitled to draw amounts sufficient to pay the purchase price of any bonds that cannot be resold. During any such period the Commonwealth is required to pay the bank(s) at an interest rate based on their respective prime lending rates. If the remarketing agent is unable to resell any put bonds within six months of the put date, the stand-by bond-purchase agreements include provisions to convert any such bonds to installment loans payable over an extended period of time, with interest payable at a rate based on the bank(s) prime lending rate(s). The stand-by bond-purchase agreements expire on various dates between December of 2003 and January of 2010. The Commonwealth is required to renew or replace these agreements as long as the VRDBs remain outstanding. The Commonwealth currently pays an annual fee to maintain these agreements, which range from 0.10% to 0.21% of the par amount of the bonds.

*Other Variable Rate Bonds*

As part of its refunding activities during FY03, the Commonwealth issued \$97,455,000 of refunding bonds which pay a variable rate interest that depends on changes in the Consumer Price Index (CPI). These bonds, which pay interest every six months, are not subject to periodic remarketing, nor do bondholders have the right to "put" such bonds back to the Commonwealth.

*Auction Rate Securities*

Also included in the long-term debt is \$401,500,000 of general obligation Auction Rate Securities (ARS) maturing in varying amounts from 2020 through 2030. The interest rate payable on the bonds changes weekly as determined pursuant to specified auction procedures. Interest on the bonds is payable weekly. In the case of a failed auction (i.e., insufficient bids to clear the market)

existing buyers may be required to hold their bonds with interest payable at rate equal to a percentage of an ARS industry index, up to a maximum rate of 12.0%.

#### **B. *Special Obligation Bonds***

The Commonwealth also issues special obligation revenue bonds as authorized by Massachusetts General Laws. Such bonds are secured by all or a portion of revenues credited to the Highway Fund and are not general obligations of the Commonwealth. At June 30, 2003, the Commonwealth had outstanding \$813,045,000 of such special obligation bonds, of which \$739,061,000 is allocated to debt not subject to the Commonwealth's statutory debt limit. These bonds are secured by a pledge of 6.86 cents of the 21 cent motor fuel excise tax imposed on gasoline.

In June of 2002, the Commonwealth sold \$319,130,000 of special obligation revenue bonds, Series 2002A. Of this amount, \$183,180,000 was issued to refund prior special obligation bonds. The remainder was used to fund capital spending in the Commonwealth. The escrow funded by the refunding bonds and related premium will be used only to secure the principal related to \$190,075,000, exclusive of related call premium in previously issued special obligation bonds maturing on June 1, 2004, 2006 and 2008. The interest related to these maturities is not secured by this escrow. Rather, it will be paid from the existing stream of motor fuel excise taxes. Interest on a portion of the newly issued refunding bonds will be paid from the proceeds of the escrow until the aforementioned prior bonds are called for redemption. This technique, which is generally referred to as a "crossover refunding," results in economic savings to the Commonwealth similar to a normal refunding, but does not meet the accounting definition of defeasance of debt, in which case the defeased debt and the related escrow accounts would have been removed. Until such time as the escrow is used to repay the principal of the refunded bonds, such amounts will be reported in the Highway Capital Projects Fund.

#### **C. *Federal Highway Grant Anticipation Notes***

The Commonwealth also issued Federal Highway GANs to finance current cash flow for the Central Artery/Tunnel Project in anticipation of future federal reimbursements. Section 9 through 10D of Chapter 11 of the Acts of 1997, as amended by Chapter 121 of the Acts of 1998, authorizes the Commonwealth to sell up to \$1,500,000,000 in GANs. All Federal Highway Construction reimbursements and reimbursements from the federal highway construction trust funds are pledged to the repayment of the GANs. At June 30, 2003, the Commonwealth has \$1,499,325,000 of GANs outstanding, including accrued interest on capital appreciation bonds with maturity dates ranging from 2005 to 2015. These notes are secured by the pledge of Federal Highway Construction Reimbursements without a general obligation pledge. Under certain limited circumstances, a portion of the revenue from the Commonwealth's motor fuels excise tax may be used to pay debt service on the GANs.

#### **D. *Interest Rate Swap Agreements***

##### *Objective of the Interest Rate Swap Agreements*

In connection with the issuance of variable rate refunding bonds in 1997, 1998, 2001 and 2003, the Commonwealth entered into interest rate swap agreements with certain counterparties. The purpose of these agreements is to effectively fix the interest rate payable on the corresponding variable rate refunding bonds, and to achieve an all-in synthetic interest rate that is lower than the rate that could have been achieved on a natural fixed rate basis at the time the agreements were entered into.

*Terms of the Interest Rate Swap Agreements*

The bonds and related swap agreements have final maturities ranging from 2013 to 2021. The swaps' total notional value of \$1,364,480,000 matches the par amount of the related variable rate refunding bonds. Under the swap agreements, the Commonwealth pays the relevant counterparties' fixed rates ranging from 4.15% to 4.659% and receives variable rate payments equal to the amount of variable rate payments the Commonwealth pays on the related variable rate refunding bonds. For the majority of the bonds, the variable rate interest payments are determined by remarketing agents on either a weekly or daily basis. For a small portion of the relevant bonds, the variable rate is determined based on the change in the Consumer Price Index.

The following chart details the Commonwealth's outstanding swaps and related bond issuances:

<b>Associated Refunding Issue</b>	<b>Notional Amounts (thousands)</b>	<b>Effective Date</b>	<b>Fixed Rate Paid</b>	<b>Variable Rate Received</b>	<b>Fair Market Values (thousands)</b>	<b>Swap Termination Date</b>	<b>Counterparty Credit Rating</b>
Series 1997B	\$ 162,768	8/12/1997	4.659%	Actual Bond Rate	\$ (28,036)	August 1, 2015	AA+/Aaa
Series 1997B	108,512	8/12/1997	4.659%	Actual Bond Rate	(17,937)	August 1, 2015	AAA/Aaa
Series 1998A & B	299,712	9/17/1998	4.174%	Actual Bond Rate	(39,753)	September 1, 2016	AAA/Aaa
Series 1998A & B	199,808	9/17/1998	4.174%	Actual Bond Rate	(23,245)	September 1, 2016	AAA/Aaa
Series 2001B & C	496,225	2/20/2001	4.150%	Actual Bond Rate	(69,776)	January 1, 2021	AAA/Aaa
Series 2003B	87,455	3/12/2003	4.500%	Actual Bond Rate	(5,340)	December 1, 2014	AA+/Aaa
Series 2003B	<u>10,000</u>	3/12/2003	4.500%	Actual Bond Rate	<u>(19)</u>	December 1, 2013	A/A2
Totals	\$ <u>1,364,480</u>				\$ <u>(184,106)</u>		

*Fair Market Value of the Interest Rate Swap Agreements*

Swap rates for the types and remaining terms of the Commonwealth's swap agreements are generally lower (as of June 30, 2003) than those that prevailed when the various swap contracts were entered into. This is the result of two factors: (1) lower interest rates in general; and (2) the shortening of the remaining terms of the swap contracts due to the passage of time and an upward sloping yield curve for such instruments. As a result, the Commonwealth's swap agreements have an estimated fair market value of negative \$184,107,000 as of June 30, 2003. If all the Commonwealth's swap agreements had been terminated as of the end of fiscal year 2003, the Commonwealth would have been required to make a payment of this magnitude. Although the Commonwealth has the option of terminating its swap agreements at any time (and either make or receive any termination payment due), the Commonwealth's counterparties do not have such an option. Therefore, the Commonwealth would only have to make a payment of the magnitude estimated if certain termination events occurred, as described below.

*Credit Risk of the Interest Rate Swap Agreements*

The swap contracts require that the Commonwealth's counterparties maintain certain ratings levels. If they fail to maintain such ratings, the Commonwealth could choose to terminate the related swap agreement and receive or pay a termination payment depending on the interest rates at the time. Similarly, the Commonwealth is required to maintain a certain credit rating under the agreements, generally in the "A" category. If the Commonwealth's rating fell

below those levels, the Commonwealth's counterparties could choose to make variable rate payments based on a market index (instead of the actual bond rate) which would subject the Commonwealth to basis risk, as noted below.

*Basis, Market and Rollover Risk of the Interest Rate Swap Agreements*

Because the terms on the interest rate swap agreements require the Commonwealth's counterparties to make variable rate payments equal to those the Commonwealth makes on the related variable rate bonds, the Commonwealth is not generally subject to any basis or market risk as a result of these agreements. Under certain circumstances, such as a downgrade of the credit rating of the bonds or the enactment of tax-related legislation which causes the related bonds to trade differently, the swap agreements provide that the Commonwealth's counterparties, may, at their option, pay a variable rate that is based on one or more market indices such as LIBOR or the BMA swap index. Under these circumstances, the Commonwealth would be subject to basis risk if these indices varied significantly from the variable rates that were determined for the Commonwealth's variable rate demand bonds through the associated remarketing process.

The swap contracts have the same maturity dates and amortizations as the related bonds. Therefore, the Commonwealth is not subject to any rollover risk as a result of these agreements.

*Termination Risk of the Interest Rate Swap Agreements*

The swap contracts use the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The swap agreements are not otherwise subject to termination except at the Commonwealth's option. If one or more of the swap agreements were terminated, then related variable rate bonds would no longer be hedged and the Commonwealth would no longer be paying a synthetic fixed rate with respect to the bonds. In addition, if at the time of termination, the swap had a negative fair value, the Commonwealth would incur a loss and would be required to settle with the related counterparty or counterparties at the swaps' fair market values.

Debt service on the variable rate bonds is as follows:

Fiscal Year Ending June 30	Variable-Rate Bonds		Interest Rate Swaps, Net	Total
	Principal	Interest		
2004	\$ -	\$ 28,264,150	\$ 30,203,563	\$ 58,467,713
2005	-	28,264,150	30,203,563	58,467,713
2006	-	28,264,150	30,203,563	58,467,713
2007	-	28,264,150	30,203,563	58,467,713
2008	2,340,000	28,229,050	30,165,409	60,734,459
2009-2013	358,785,000	130,350,992	138,563,416	627,699,408
2014-2018	722,845,000	57,648,875	61,473,058	841,966,933
2019-2023	280,510,000	9,119,417	9,803,373	299,432,790
Total	<u>\$ 1,364,480,000</u>	<u>\$ 338,404,934</u>	<u>\$ 360,819,508</u>	<u>\$ 2,063,704,442</u>

**E. Outstanding Debt**

For financial reporting purposes, long-term debt is carried at its face value, which includes discount and any issuance costs. The outstanding amount represents the total principal to be repaid. For capital appreciation bonds, the outstanding amount represents total principal and accreted interest to be repaid. When short-term debt has been refinanced on a long-term basis, it is reported as outstanding at its face amount.

The amount of long-term debt authorized but unissued is measured in accordance with the statutory basis of accounting. Only the net proceeds (exclusive of discount and costs of issuance) are deducted from the total authorized by the Legislature.

Changes in long-term debt outstanding (including discount and issuance cost) and bonds authorized - unissued for the year ended June 30, 2003 are as follows (amounts in thousands):

	Bonds Outstanding	Authorized and Unissued
Balance July 1, 2002.....	\$ 14,955,135	\$ 8,483,658
General and special obligation bonds:		
Principal, less discount and issuance costs.....	1,911,201	(1,911,201)
Net premium and issuance costs.....	(65,743)	-
General obligation refunding bonds:		
Principal on Refunding Bonds.....	3,122,435	-
Principal on Refunded Bonds.....	(3,227,427)	-
Retired discount on Refunded Bonds.....	4,737	-
Increase in bonds authorized.....	-	2,149,124
Bonds retired.....	(737,832)	-
Balance June 30, 2003.....	<u>\$ 15,962,506</u>	<u>\$ 8,721,581</u>

*Business Type Activities – Colleges and University Debt*

Building authorities related to the University of Massachusetts and the state colleges have issued bonds for construction of higher education facilities and equipment. Such bonds are guaranteed by the Commonwealth in an aggregate amount not to exceed \$278,000,000. The bond agreements generally provide that revenues from student fees are pledged as collateral on the bonds and establish bond reserve funds, bond funds, and maintenance reserve funds. The University of Massachusetts and state colleges have also entered into various loan agreements as participants in the Massachusetts Health and Educational Facilities Authority's (MHEFA) ongoing capital asset program to finance construction projects and equipment.

At June 30, 2003, debt service requirements to maturity for principal (including discount, capital appreciation and issuance costs) and interest including all variable rate interest not hedged by swap agreements (assumed interest rate is 5%) are as follows (amounts in thousands):

Fiscal Year Ended June 30	Governmental Activities		Business - Type Activities	
	General Obligation		Revenue Obligation	
	Principal	Interest	Principal	Interest
2004 .....	\$ 728,485	\$ 791,228	\$ 25,967	\$ 33,771
2005 .....	851,827	755,822	19,985	32,251
2006 .....	979,782	716,367	21,137	31,309
2007 .....	1,018,407	667,569	22,148	30,301
2008 .....	1,046,640	616,805	24,705	29,250
2009 - 2013 .....	4,927,506	2,275,956	133,434	128,109
2014 - 2018 .....	3,385,527	1,163,392	125,056	93,556
2019 - 2023 .....	2,027,979	494,342	116,539	61,823
2024 - 2028 .....	388,374	219,257	82,685	36,910
2029 - 2033 .....	607,979	46,726	98,998	11,812
2034 - 2038 .....	-	-	2,744	215
Total long - term debt .....	15,962,506	7,747,464	673,398	489,307
Less: Current Portion .....	(728,485)	(791,228)	(25,967)	(33,771)
Long - term debt .....	<u>\$ 15,234,021</u>	<u>\$ 6,956,236</u>	<u>\$ 647,431</u>	<u>\$ 455,536</u>

The Commonwealth issued bonds and notes through both competitive and negotiated sales during FY03. The costs for legal counsel and underwriting fees for bond sales were \$667,000 and \$22,758,000 respectively. In addition, the Commonwealth paid \$166,000 for disclosure counsel services.

#### ***F. Bonds Defeased Through Refunding***

As authorized by the Massachusetts General Laws, the Commonwealth advance refunded certain general obligation bonds through the issuance of \$3,122,435,000 of general obligation refunding bonds (exclusive of the aforementioned special obligation refunding bonds) during FY03. Net proceeds totaling approximately \$3,396,027,000 were used to purchase U.S. Government and U.S. Government Agency securities which were deposited in irrevocable trusts with an escrow agent to provide for all future debt service payments of the refunded bonds. As a result, the refunded bonds are considered to be defeased, and the liabilities therefore have been removed from Long-term Obligations in the Statement of Net Assets. As a result of this refunding, the Commonwealth decreased current year debt service payments and has taken advantage of lower interest rates, and it has decreased its aggregate debt service payments by approximately \$149,495,000 over the next 20 years and will experience an economic gain (the difference between the present values of the debt service payments of the refunded and refunding bonds) of approximately \$127,753,000. At June 30, 2003, approximately \$2,351,885,000 of the bonds refunded remain outstanding and are defeased.

#### ***G. Prior Defeasance***

In prior years, the Commonwealth defeased certain general and special obligation bonds by purchasing securities (from the proceeds of refunding bonds or from surplus operating funds) and placing them in irrevocable trusts to provide for all future debt service payments on the defeased bonds. Accordingly, the trust account assets and the liabilities for the defeased bonds are not included in the financial statements. At June 30, 2003, approximately \$3,615,898,000 of bonds refunded and defeased in prior fiscal years remain outstanding.

**H. Statutory Debt Limit**

The Massachusetts General Laws establish limits on the amount of direct debt outstanding. By statutorily limiting the Commonwealth's ability to issue direct debt, this limit provides a control on annual capital spending. The direct debt limit for FY03 was approximately \$12,211,823,000. Outstanding debt subject to the limit at June 30, 2003 was approximately \$11,566,472,000. The limit increases 5% per year.

For purposes of determining compliance with the limit, outstanding direct debt is defined to include general obligation bonds and minibonds at the amount of their original net proceeds. It excludes BANs and discount and issuance costs, if any, financed by these bonds. It also excludes special obligation bonds, GANs, refunded bonds, certain refunding bonds, debt issued by counties, and debt issued in conjunction with the MBTA forward funding.

The amounts excluded from the debt limit are as follows (amounts in thousands):

	<u>Debt Outstanding</u>
Balance June 30, 2003.....	\$ 15,962,506
Less amounts excluded:	
Discount and issuance cost.....	(68,718)
Chapter 5 of the Acts of 1992 Refunding.....	(10,600)
Special Obligation Principal.....	(748,124)
GANs Principal.....	(1,500,000)
County Debt Assumed.....	(855)
MBTA Forward Funding.....	(680,869)
Central Artery Tunnel.....	(1,386,868)
Outstanding Direct Debt.....	<u>\$ 11,566,472</u>

**I. Changes in Long – Term Liabilities**

Other long-term liabilities will be liquidated in the future from governmental funds. During the year ended June 30, 2003, the following changes occurred in liabilities reported as part of the long-term liabilities in the statement of net assets (amounts in thousands):

<i>Primary Government Governmental Activities</i>	Interest Rates	Maturity Through	July 1, 2002 Beginning Balance	Increases	Decreases	June 30, 2003 Ending Balance	Due Within One Year
Long - term debt:							
General obligation bonds .....	0.00 - 8.00%	2031	\$ 12,500,411	\$ 5,033,636	\$ 3,890,210	\$ 13,643,837	\$ 633,548
Special obligation bonds .....	4.00 - 5.50%	2017	772,812	-	24,688	748,124	25,933
Grant anticipation notes .....	0.00 - 7.00%	2015	1,500,000	-	-	1,500,000	-
Unamortized (Premiums) / Discounts:							
General obligation bonds .....			191,473	(65,743)	45,447	80,283	68,867
Special obligation bonds .....			(8,886)	-	177	(9,063)	137
Grant anticipation notes .....			(675)	-	-	(675)	-
Total long - term debt .....			14,955,135	4,967,893	3,960,522	15,962,506	\$ 728,485
Less: Current Portion.....			(744,830)	728,485	744,830	(728,485)	
Net long - term debt .....			14,210,305	5,696,378	4,705,352	15,234,021	
Other long - term liabilities:							
Due to Component Units - Central Artery / Tunnel Project.....			9,301,140	1,063,006	78,587	10,285,559	
Due to Related organizations.....			365,000	-	-	365,000	
School construction grants and other contract assistance payable.....			3,656,598	99,095	207,749	3,547,944	
Other liabilities.....			551,173	388,759	341,194	598,738	
Total Other long - term liabilities.....			13,873,911	1,550,860	627,530	14,797,241	
Total non - current liabilities .....			\$ 28,084,216	\$ 7,247,238	\$ 5,332,882	\$ 30,031,262	

<i>Business - Type Activities</i>	<u>Interest Rates</u>	<u>Maturity Through</u>	<u>July 1, 2002 Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>June 30, 2003 Ending Balance</u>	<u>Due Within One Year</u>
Long - term debt:							
Revenue obligation debt .....	0.0 - 7.5%	2037	\$ 670,430	\$ 33,250	\$ 30,282	\$ 673,398	\$ 25,967
Other long - term liabilities:							
Compensated absences .....			140,423	18,492	16,488	142,427	88,371
Capital lease obligations.....			79,880	38,981	26,927	91,934	18,902
Other liabilities.....			149,750	48,994	111,779	86,965	-
Total Other long - term liabilities.....			370,053	106,467	155,194	321,326	-
Total Long - term liabilities.....			1,040,483	139,717	185,476	994,724	\$ 133,240
Less: Current Portion.....			(187,705)	133,240	(187,705)	133,240	
Total non - current liabilities .....			\$ 852,778	\$ 6,477	\$ (2,229)	\$ 861,484	

**Discretely Presented Component Units** – Bonds and notes outstanding at June 30, 2003 (December 31, 2002 for Massachusetts Turnpike Authority), net of unamortized discounts and premiums, along with unamortized losses on refundings of approximately \$282,781,000, are as follows (amounts in thousands):

<i>Discretely Presented Component Units</i>			<u>July 1, 2002 Beginning Balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>June 30, 2003 Ending Balance</u>	<u>Due Within One Year</u>
Major component units:							
MBTA .....	3.85 - 7.80%	2004-2030	\$ 3,879,721	\$ 727,675	\$ 417,056	\$ 4,190,340	\$ 92,495
MTA .....	5.05 - 5.65%	2004-2039	2,541,083	-	12,295	2,528,788	13,050
MWPAT .....	3.00 - 6.375%	2004-2030	1,736,425	391,685	73,050	2,055,060	87,245
Nonmajor component units .....	1.77 - 9.00%	2004-2034	1,123,255	313,649	225,286	1,211,618	35,495
Total bonds payable .....			9,280,484	1,433,009	727,687	9,985,806	228,285
Compensated absences .....			25,576	23,661	24,556	24,681	18,630
Total Component Units .....			\$ 9,306,060	\$ 1,456,670	\$ 752,243	\$ 10,010,487	\$ 246,915

The amounts below represent the gross face amounts of bonds and notes outstanding and may differ from the amounts included in the combined balance sheet due to treatment of original issue discount in the general-purpose financial statements. Maturities of principal and interest are as follows (amounts in thousands):

<u>Fiscal Year Ended June 30,</u>	<u>Massachusetts Bay Transportation Authority</u>		<u>Massachusetts Turnpike Authority</u>		<u>Massachusetts Water Pollution Abatement Trust</u>		<u>Nonmajor Component Units</u>		<u>Total</u>	
	<u>Principal</u>	<u>Interest</u>	<u>Principal</u>	<u>Interest</u>	<u>Principal</u>	<u>Interest</u>	<u>Principal</u>	<u>Interest</u>	<u>Principal</u>	<u>Interest</u>
2004.....	\$ 91,355	\$ 217,079	\$ 13,050	\$ 120,973	\$ 87,245	\$ 104,315	\$ 87,666	\$ 64,835	\$ 279,316	\$ 507,202
2005.....	103,075	212,776	39,935	119,066	88,945	100,519	40,928	64,378	272,883	496,739
2006.....	120,260	208,993	19,535	118,054	90,110	96,550	35,774	61,465	265,679	485,062
2007.....	139,540	204,880	19,890	117,009	92,680	96,083	30,817	52,543	282,927	470,515
2008.....	150,885	197,268	193,885	559,482	94,840	87,718	58,879	122,633	498,489	967,101
2009 - 2013.....	852,110	851,369	189,770	515,856	499,405	367,041	149,431	223,347	1,690,716	1,957,613
2014 - 2018.....	818,600	604,809	365,502	564,198	487,700	232,135	206,247	178,106	1,878,049	1,579,248
2019 - 2023.....	910,640	373,653	239,917	497,454	359,780	114,242	203,222	146,648	1,713,559	1,131,997
2024 - 2028.....	689,735	151,060	310,718	418,555	172,850	43,220	201,521	107,033	1,374,824	719,868
2029 - 2033.....	310,730	14,976	137,945	176,477	81,505	7,755	129,875	32,958	660,055	232,166
2034 - 2038.....	-	-	998,641	21,522	-	-	55,395	15,920	1,054,036	37,442
Total long - term debt*.....	4,186,930	3,036,863	2,528,788	3,228,646	2,055,060	1,249,578	1,199,755	1,069,866	9,970,533	8,584,953
Less: Current portion*.....	(91,355)	(217,079)	(13,050)	(120,973)	(87,245)	(104,315)	(87,666)	(64,835)	(279,316)	(507,202)
Long - term debt*.....	\$ 4,095,575	\$ 2,819,784	\$ 2,515,738	\$ 3,107,673	\$ 1,967,815	\$ 1,145,263	\$ 1,112,089	\$ 1,005,031	\$ 9,691,217	\$ 8,077,751

\* Does not include certificates of participation described below.

The MBTA issued certificates of participation (COPs) in the amounts of approximately \$28,565,000 on December 15, 1988 and approximately \$85,795,000 on August 30, 1990 to finance the purchase of commuter rail coaches. Under the terms of the "Forward Funding" of the MBTA, the COPs payments are not reimbursable by the Commonwealth, but are guaranteed.

The certificates bear interest at rates ranging from 7.30% to 7.80% and mature as follows (amounts in thousands):

<u>Fiscal Year Ended June 30</u>	<u>Principal</u>	<u>Interest</u>
2004.....	\$ 1,140	\$ 264
2005.....	1,135	176
2006.....	<u>1,135</u>	<u>88</u>
	3,410	528
Less: Current Portion.....	<u>(1,140)</u>	<u>-</u>
Long Term Portion.....	<u>\$ 2,270</u>	<u>\$ 528</u>

The remaining outstanding principal balance of COPs that were defeased in-substance in prior years is \$9,075,000 at June 30, 2003.

In prior years, the MBTA defeased in-substance several General Transportation System Bonds by placing the proceeds of new bonds in an irrevocable trust fund to provide for future debt service payments on the old debt. Accordingly, the trust account asset and the liability for the defeased bonds are not included in the accompanying financial statements. On June 30, 2003, approximately \$663,545,000 of these bonds outstanding are considered defeased.

*Interest Rate Swap Agreements – Discretely Presented Component Units*

The MBTA and R3N have entered into interest rate swaps and swaptions (referred to herein collectively as Swaps) in order to lower its cost of capital, protect against rising interest rates, lock in rate savings and to realize refinancing savings according to schedules that suit the Component Units' needs. When the Component Unit has entered into Swaps, it has done so in order to: (1) provide lower costs fixed rate financing for its capital needs through synthetic fixed rate structures; (2) lock in long – term fixed rate returns on invested assets in its required reserve funds; and (3) create synthetic refinancing with cash flow savings realized as the Component Unit designates.

*Summary of Swap Transactions by Category – Synthetic Fixed Rate Swap Transactions*

From FY00 through FY02, MBTA and R3N executed swap agreements, associated with particular series of bonds. On one of the agreements, the MBTA will receive a \$4,338,000 payment for the counterparty, due in FY07. The transactions are summarized as follows: (amounts in thousands):

Fixed Rate <u>Paid</u>	Variable Receive <u>Rate</u>	Component <u>Unit</u>	Notional <u>Amount</u>	Effective <u>Date</u>	Maturity <u>Date</u>	Fair Value
4.93%	BMA	MBTA	\$ 188,000	June, 2000	2005	\$ (16,416)
5.20%	BMA	MBTA	87,805	December, 2001	2022	(16,703)
4.53%	67% of LIBOR	R3N	294,000	May, 2002	2033	9,387
			<u>\$ 569,805</u>			<u>\$ (23,732)</u>

*Swap Payments and Associated Debt*

As of June 30, 2003, debt service requirements of the MBTA's variable rate bonds and net swap payments, applying a fixed rate of 4.93%, for the MBTA's 2000 series bonds, a fixed rate of 5.2% for the 2003 series bonds and assuming the BMA rate is .98% for all, with a variable rate on the applicable bonds is .95% for 2000 and 1.10% for the 2003 bonds, through the term of the swap were as follows. As rates vary, variable interest rate payments on the bonds and net swap payments will vary (amounts in thousands).

Fiscal Year Ending June 30,	Variable - Rate Bonds		Interest Rate Swap, Net	Total
	Principal	Interest		
2004 .....	\$ -	\$ 2,705	\$ 11,128	\$ 13,833
2005 .....	-	2,705	11,128	13,833
2006 .....	-	1,216	4,942	6,158
2007 .....	-	919	3,705	4,624
2008 .....	-	919	3,705	4,624
2009 - 2013 .....	5,995	4,594	18,527	29,116
2014 - 2018 .....	35,960	3,578	14,429	53,967
2019 - 2023 .....	45,850	1,383	5,577	52,810
	<u>\$ 87,805</u>	<u>\$ 18,019</u>	<u>\$ 73,141</u>	<u>\$ 178,965</u>

*Swaptions for Forward Refundings*

In addition, the MBTA has four swaptions generally exercisable from FY06 through FY11 on its variable rate general transportation system bonds. The swaptions are summarized as follows (amounts in thousands):

Execution Date	Notional Amount	Lump - Sum Payment From Counterparty	Due date of Payment	Counterparty Option Exercise Dates	Term of Swap	Fixed Payable Swap Rate	Variable Receivable Swap Rate	Counterparty Credit Rating as of June 30, 2003	Fair Value at June 30, 2003
FY02	\$ 188,000	\$ 12,230	FY06	Each March & September 2005 - 2010	2030	5.000%	67% of one-month LIBOR	Aa2 / AA+	\$ (22,796)
FY02	79,645	4,140	FY06	Each March & September 2009 - 2011	2030	5.610%	BMA	Aaaa / AAA	(6,087)
FY03	123,170	10,833	In annual installments from FY04 to FY20	Each March & September 2005 - 2010	2025	5.093%	BMA	Aa2 / AA+	(8,061)
FY03	96,085	6,728	In annual installments from FY04 to FY20	Each March & September 2006 - 2011	2026	5.037%	BMA	Aa2 / AA+	(5,400)
	<u>\$ 486,900</u>	<u>\$ 33,931</u>							<u>\$ (42,344)</u>

*Credit Risk*

Because all of R3N's and MBTA's swaps rely upon the performance of third parties who serve as swap counterparties, both are exposed to credit risk, or the risk that a swap counterparty fails to perform according to its contractual obligations. The appropriate measurement of this risk at the reporting date is the fair value of the swaps. All fair values have been calculated using the Mark to Market or Par Value Method. To mitigate credit risk, the Component Units maintain strict credit standards for swap counterparties. For the MBTA, all swap counterparties for both Moody's and Standard & Poors rate longer-term swaps are in the "AA" category. On the MBTA's swap that matures in FY06, the counterparty is rated in the "A" category by both agencies. To further mitigate credit risk, the MBTA's swap documents require counterparties to post collateral for the MBTA's benefit if they are downgraded below a designated threshold.

*Basis Risk*

Both R3N and the MBTA are exposed to basis risk if the relationship between the floating index the MBTA receives on the swaps (BMA or 67% of LIBOR) falls short of the variable rate on the associated bonds. Should this occur, the expected savings may not be realized. As of June 30, 2003, the BMA rate was .98% while the variable rates on the associated MBTA bonds ranged from .95% to 1.1%. For R3N, the BMA rate assumed was 1.5%.

*Termination Risk*

R3N's and the MBTA's swap agreements do not contain any out of the ordinary events that would expose them to significant termination risk. In keeping with market standards, all parties may terminate each swap if the other party fails to perform under the terms of the contract. In addition the swap documents allow either party to terminate in the event of a significant loss of creditworthiness. Both R3N and the MBTA view such events to be remote. If at the time of the termination a swap has a negative value, R3N or the MBTA would be liable to the counterparty for a payment equal to the fair value of each swap.

*Rollover Risk*

Only the MBTA's 2000 series bonds are exposed to rollover risk because the swap for the bonds terminates prior to maturity of the bonds. Upon termination of the swap, the MBTA will no longer realize the synthetic rate on the 2000 bonds and will be exposed to floating rate risk on the underlying bonds if no new hedge is put in place. The R3N bonds are not subject to rollover risk.

*Market Access Risk and Potential Basis Risk*

In the case of the swaptions, other than the FY02 swaption, if any option is exercised and refunding bonds are not issued, the bonds expected to be refunded would not be refunded and the MBTA would make net swap payments as required by the terms of each contract. There is no market access risk for the FY02 swaption. If any of the options are exercised, the actual savings ultimately recognized by the transactions will be affected by the relationship between the interest rate terms of the variable rate bonds versus the variable payment on the swap.

**J. Bond Issuances Subsequent to June 30, 2003**

The following bond and note series were issued subsequent to June 30, 2003 but before the date of audit opinion (amounts in thousands):

<u>Description</u>	<u>Issue Size</u>	<u>Refunding Portion</u>	<u>Interest Rate Range %</u>	<u>FY of Maturities</u>
<b><u>Primary Government</u></b>				
Special Obligation Refunding Notes - (Federal Grant Anticipation Notes) 2003 Series A - a crossover refunding	\$ 408,015	\$ 408,015	2.51%-3.39%	2009-2014
General Obligation Bonds Consolidated Loan of 2003 Series B and C	475,000	-	2%-5.25%	2004-2023
College Opportunity Bonds Series 2003A	6,343	-	Variable	2008-2023
General Obligation Bonds Consolidated Loan of 2003 Series D and General Obligation Refunding Bond, 2003 Series D	1,033,595	762,285	2.71%-5.50%	2004-2024
<b><u>Discretely Presented Component Units</u></b>				
Massachusetts Water Pollution Abatement Trust: Pool Program Bonds Series 9	311,580	-	2%-5.50%	2004-2023

## 9. INDIVIDUAL FUND DEFICITS

Certain funds within the Governmental Fund Type have fund deficits at June 30, 2003 as follows (amounts in thousands):

<u>Fund</u>	<u>Amount</u>
Major governmental funds:	
Highway .....	\$ 582,429
Lotteries.....	14,185
Other governmental funds:	
Federal Grants.....	5,928
General Capital Projects.....	282,861
Convention and Exhibition Center.....	502,569
Capital Expenditure Reserve.....	98,829
Highway Capital Projects .....	270,567

## 10. RETIREMENT SYSTEMS

### *Primary Government*

The Commonwealth is statutorily responsible for the pension benefits for Commonwealth employees (members of the State Employees' Retirement System) and for teachers of the cities, towns, regional school districts throughout the Commonwealth and Quincy College (members of the Teachers' Retirement System, except for teachers in the Boston public schools, who are members of the State-Boston Retirement System but whose pensions are also the responsibility of the Commonwealth). The members of the retirement systems do not participate in the Social Security System.

The Commonwealth has assumed responsibility for payment of cost-of-living adjustments (COLA) for the separate (non-teacher) retirement systems of its cities, towns and counties, granted in fiscal year 1981 to 1996. The Commonwealth is statutorily required to have an actuarial valuation once every three years and every two years for GAAP reporting purposes.

### *Plan Descriptions*

The *State Employees' Retirement System* (SERS) is a single employer defined benefit public employee retirement system (PERS), covering substantially all employees of the Commonwealth and certain employees of the independent authorities and agencies, including the state police officers at the Massachusetts Port Authority and the Massachusetts Turnpike Authority. The SERS is administered by the Commonwealth and is part of the reporting entity and does not issue a stand alone financial report.

Certain Commonwealth employees and current retirees employed prior to the establishment of the State Employees' Retirement System are covered on a "pay-as-you-go" basis. During the year ended June 30, 2003, the Commonwealth's pension expenditure included payments totaling \$16,711,000 to current retirees employed prior to the establishment of the current plans and the non-contributory plans.

The *Teachers' Retirement System* (TRS) is an agent multiple employer defined benefit PERS. The Commonwealth is a non-employer contributor and is responsible for all contributions and future benefit requirements of the TRS. The TRS covers certified teachers in cities (except the City of Boston), towns, regional school districts and Quincy College. The TRS is administered by the Commonwealth and is part of the reporting entity and does not issue a stand-alone financial report.

The *State – Boston Retirement System* (SBRS) is a hybrid multiple employer defined benefit PERS. SBRS provides pension benefits to all full-time employees upon commencement of employment with any of the various government agencies covered by SBRS. The Commonwealth is a non-employer contributor and is only responsible for the actual cost of pension benefits for SBRS participants who serve in the City of Boston's School Department in a teaching capacity (BTRS). The cost of pension benefits of the other participants is the responsibility of the City of Boston. SBRS is not administered by the Commonwealth and is not part of the reporting entity and a stand-alone financial report is not available.

The SERS, TRS and SBRS are using "Entry Age Normal Cost" method to determine pension liabilities. The actuarial value of assets is determined in accordance with the deferred recognition method under which 20% of the gains or losses occurring in the prior year are recognized, 40% of those occurring 2 years ago, etc., so that 100% of gains and losses occurring 5 years ago are recognized. The actuarial value of assets will be adjusted, if necessary, in order to remain between 85% and 115% of market value.

The policy for post-retirement benefit increases for all retirees of the SERS, TRS, BTRS and COLA of local governments is subject to legislative approval.

Membership – Membership in SERS, TRS and BTRS as of January 1, 2003, the date of the most recent valuation, is as follows:

	<u>SERS</u>	<u>TRS</u>	<u>BTRS</u>
Retirees and beneficiaries			
currently receiving benefits.....	48,766	37,041	2,696
Terminated employees entitled to benefits but not yet receiving them....	2,756	N/A	161
Subtotal.....	<u>51,522</u>	<u>37,041</u>	<u>2,857</u>
Current employees:			
Vested*.....	42,151	44,909	3,716
Non-vested*.....	40,001	44,097	2,681
Subtotal.....	<u>82,152</u>	<u>89,006</u>	<u>6,397</u>
Total.....	<u>133,674</u>	<u>126,047</u>	<u>9,254</u>

\* Estimated

*Benefit Provisions*

Massachusetts General Laws established uniform benefit and contribution requirements for all contributory PERS. These requirements provide for retirement allowance benefits up to a maximum of 80% of a member's highest three-year average annual rate of regular compensation. Benefit payments are based upon a member's age, length of creditable service, and group creditable service, and group classification. The authority for amending these provisions is with the Legislature.

Members become vested after ten years of creditable service. A superannuation retirement allowance may be received upon the completion of twenty years of service or upon reaching the age of 55 with ten years of service. Normal retirement for most employees occurs at age 65; for certain hazardous duty and public safety positions, normal retirement is at age 55.

*Funding Progress*

During FY01, the Legislature passed Chapter 114 of the Acts of 2000, which modified Chapter 32 of the General Laws. This modification became effective on July 1, 2001. In Chapter 114, teachers who are members of the State Teachers Retirement System, or teachers who are members of the State – Boston Retirement System before 1975, who resigned or took an unpaid leave of absence because of maternity leave will be allowed to “buy back” into the fund up to a maximum of four years. The member must pay the amount determined by the Retirement Board by December 31, 2001 to qualify, as long as the member has worked longer than ten years. If the member completes ten years of service after December 31, 2001, payment can be made within 18 months of completion of ten years of service. In addition, the law creates a superannuation retirement benefit program for all teachers hired on or after July 1, 2001. This program has a contribution rate of 11 percent of regular compensation. To be eligible for the alternative benefit at retirement, the teacher must have completed thirty years of eligible service. All previous members may elect to participate in the program, as long as they participate with the equivalent of a minimum of five years of employee contributions at the new rate. If the member retires before five years, the teacher must pay into the system, the amount that would have been paid in one lump sum, or in installments as the Board may prescribe. The alternative benefit is calculated as the percentage of average compensation determined under the current formula increased by 2% of the average annual compensation for each full year of service in excess of 24 years. The election to participate is irrevocable.

The SERS, TRS and BTRS actuarial determined contributions were computed as part of the actuarial valuation as of January 1, 2001. These assumptions remained the same for the January 1, 2003 valuation. The Commonwealth revised the actuarial assumptions used in the calculation of contribution requirements and Unfunded Actuarial Liability (UAL) effective January 1, 2001. The revised actuarial assumptions were the result of an experience study performed for the Commonwealth for the period 1995 to 1999 concluded in FY01.

The actuarial value of assets used to derive the UAL from January 1, 1990 to January 1, 1996 reflected the market value of plan assets. Beginning the January 1, 1998 actuarial valuation, the Commonwealth began implementing a method that averages realized and unrealized asset gains and losses over 5 years.

The most significant assumptions for the actuarial valuation are investment return and rate of salary increase. The valuation as of January 1, 2003 assumes an investment return rate of 8.25% per year. The salary increase is based on years of service and may also vary by age and job groups. The rate of salary increase assumption ranges from 4.75% to 12.00%. Other assumptions include mortality, disability, turnover and retirement rates, along with cost of living increase.

The following table presents the schedule of funding progress as presented in the most recent actuarial valuations at the dates indicated (amounts in thousands):

Actuarial Valuation as of January 1	Actuarial Value of Plan Assets	Actuarial Accrued Liability	Unfunded Actuarial Liability (UAL)	Funded Ratio %	Annual Covered Payroll *	UAL as a % of Covered Payroll
State Employees' Retirement System						
2003	\$ 13,947,000	\$ 17,551,000	\$ 3,604,000	79.5 %	\$ 3,779,000	95.4 %
2002	15,002,000	15,961,000	959,000	94.0	4,034,000	23.8
2001	13,922,000	15,170,000	1,248,000	91.8	3,700,000	33.7
2000	13,364,000	14,138,000	773,000	94.5	3,472,000	22.3
1998	9,914,000	11,361,000	1,447,000	87.3	3,111,000	46.5
1996	7,366,000	9,441,000	2,075,000	78.0	2,989,000	69.4
1995	5,879,000	8,602,000	2,723,000	68.3	2,992,000	91.0
1993	5,071,000	8,738,000	3,667,000	58.0	2,919,000	125.6
1992	4,699,000	7,303,000	2,604,000	64.3	2,638,000	98.7
Teachers' Retirement System						
2003	14,762,000	22,892,000	8,129,000	64.5	4,406,000	184.5
2002	15,712,000	20,620,000	4,908,000	76.2	4,264,000	115.1
2001	14,390,000	18,170,000	3,779,000	79.2	4,072,000	92.8
2000	13,681,000	16,420,000	2,739,000	83.3	3,704,000	73.9
1998	10,170,000	13,095,000	2,925,000	77.7	3,175,000	92.1
1996	7,553,000	10,252,000	2,699,000	73.7	2,810,000	96.0
1995	6,014,000	9,712,000	3,698,000	61.9	2,667,000	138.7
1993	5,142,000	8,921,000	3,779,000	57.6	2,428,000	155.6
1992	4,784,000	8,706,000	3,922,000	55.0	2,032,000	193.0
State - Boston Retirement System ( Boston Teachers)						
2003	919,000	1,918,000	998,000	47.9	387,000	257.9
2002	984,000	1,756,000	772,000	56.0	370,000	208.6
2001	918,000	1,502,000	583,000	61.1	304,000	191.8
2000	860,000	1,381,000	521,000	62.3	285,000	182.8
1998	699,000	1,219,000	520,000	57.3	285,000	182.5
1996	549,000	1,025,000	476,000	53.6	274,000	173.7
1995	438,000	833,000	395,000	52.6	232,000	170.3
1993	370,000	743,000	373,000	49.8	206,000	181.1
1992	342,000	759,000	417,000	45.1	184,000	226.6

\* - The covered payroll amounts approximate the employer payroll.

#### *Pension Actuarial Valuation*

The Commonwealth's pension actuarial valuation was performed as of January 1, 2003 pursuant to Chapter 32 of the General Laws of the Commonwealth of Massachusetts and based on the plan provisions at that time.

*Contributions Required and Contributions Made*

The Commonwealth was financially responsible for the COLA granted to participants in the 104 retirement systems of cities, towns and counties in fiscal year 1981 to 1996. Chapter 17 of the Acts of 1997 effective for fiscal year 1998 transferred the responsibility for funding COLAs for separate (non-teacher) retirement systems of cities and towns to the respective system. Any future COLA granted by the Legislature to employees of these plans will be the responsibility of the individual system. The individual employer governments are also responsible for the basic pension benefits. The retirement systems are not administered by the Commonwealth and are not part of the reporting entity. The actuarial accrued liability for COLA as of January 1, 2003 was \$670,000,000.

The retirement systems' funding policies have been established by Chapter 32 of the Massachusetts General Laws. The Legislature has the authority to amend these policies. The annuity portion of the SERS, TRS and BTRS retirement allowance is funded by employees, who contribute a percentage of their regular compensation. Costs of administering the plan are funded out of plan assets.

Member contributions vary depending on the most recent date of membership:

<u>Hire Date</u>	<u>% of Compensation</u>
Prior to 1975	5% of regular compensation
1975 – 1983	7% of regular compensation
1984 to 6/30/96	8% of regular compensation
7/1/96 to present	9% of regular compensation
7/1/96 to present	12% of regular compensation (State Police)
7/1/01 to present	11% of regular compensation (for teachers hired after 7/1/01 and those accepting provisions of Chapter 114 of the Acts of 2000)
1979 to present	An additional 2% of regular compensation in excess of \$30,000.

The Commonwealth's contribution for the pension benefit portion of the retirement allowance of SERS and TRS and required payments to cover BTRS and COLA contributions were originally established on a "pay-as-you-go" basis. As a result, amounts were appropriated each year to pay current benefits, without a systematic provision to fully fund future liabilities already incurred. Beginning in fiscal year 1988, the Commonwealth enacted the Pension Reform Act of 1987 and addressed the unfunded liability of SERS, TRS and its participation in SBRS and its COLA obligation. Chapter 32, Section 22C of General Laws enacted in 1998 called for the payment of normal cost plus a level amortization payment of UAL such that the UAL is reduced to zero by June 30, 2018.

This legislation also directed the Secretary of Administration and Finance to prepare a funding schedule to meet these requirements, and to update this funding schedule every three years on the basis of new actuarial valuation reports prepared under the Secretary's direction. Any such schedule is subject to legislative approval. If a schedule is not so approved, payments are to be made in accordance with the most recently approved schedule. Under the

current schedule proposed on March 1, 2002, reflecting valuations as of January 1, 2001, the amortization payments are designed to eliminate the unfunded liability by fiscal year 2023 on a 4.15% increasing basis. Contributions by the Commonwealth of \$813,660,000 were made during the fiscal year ended June 30, 2003. Of this amount \$34,073,000 represents payments for COLA granted to participants in retirement systems of cities, towns and counties.

GAAP requires that pension expenditures (costs) be based on an acceptable actuarial cost method and that they be not less than:

- Normal cost plus amortization of net pension obligation cost
- Interest and amortization on any unfunded prior service costs

The funding schedule discussed above follows an acceptable actuarial funding methodology to compute normal cost and the unfunded accrued actuarial liability.

The following table presents the schedule of employer contributions (amounts in thousands):

Actuarial Valuation as of January 1	Annual Required Contribution (ARC)	Interest on NPO	Amortization of NPO	Pension Cost	Actual Contribution Made	Net Pension (Obligation) Asset (NPO)	% of ARC Contributed	% of Pension Cost Contributed
State Employees' Retirement System								
2003	\$ 397,698	\$ (117,299)	\$ (96,940)	\$ 377,338	\$ 280,929	\$ 1,325,401	71 %	74 %
2002	215,795	(111,506)	(92,152)	196,441	266,660	1,421,811	124	136
2001	275,204	(109,731)	(133,387)	298,861	320,381	1,351,592	116	107
2000	352,084	(108,400)	107,190	350,873	367,000	1,330,071	104	105
1999	319,454	(103,188)	98,556	314,822	378,000	1,313,944	118	120
1998	261,255	(83,446)	77,180	254,989	494,289	1,250,766	189	194
1997	246,037	(65,478)	41,889	222,448	463,590	1,011,466	188	208
1996	232,158	(46,918)	29,523	214,763	433,114	770,324	187	202
1995	249,640	(31,639)	19,614	237,615	417,361	551,973	167	176
1994	266,564	(18,448)	9,152	257,268	398,900	372,227	150	155
Teachers' Retirement System								
2003	651,021	(83,468)	(68,980)	636,534	417,204	792,400	64	66
2002	411,225	(82,377)	(68,079)	396,927	410,143	1,011,729	100	103
2001	475,053	(78,498)	(95,421)	491,976	539,000	998,513	113	110
2000	480,873	(79,487)	78,599	479,985	468,000	951,489	97	98
1999	373,777	(70,312)	67,155	370,620	481,826	963,474	129	130
1998	315,474	(59,126)	54,686	311,034	446,619	852,267	142	144
1997	245,426	(44,832)	28,681	229,275	418,519	716,682	171	183
1996	232,403	(30,311)	19,073	221,165	392,003	527,439	169	177
1995	277,343	(24,002)	14,880	268,221	342,441	356,601	123	128
1994	247,460	(15,975)	7,925	239,410	322,100	282,381	130	135
Boston Teachers Retirement System								
2003	76,151	3,411	2,819	76,743	52,944	(65,142)	70	69
2002	94,003	(67)	(56)	93,992	51,833	(41,343)	55	55
2001	66,820	1,542	1,875	66,488	86,000	815	129	129
2000	58,266	448	(443)	58,271	45,000	(18,697)	77	77
1999	53,453	(989)	944	53,409	36,000	(5,426)	67	67
1998	48,795	(2,114)	1,995	48,636	35,000	11,983	72	72
1997	34,621	(2,082)	1,332	33,871	35,000	25,619	101	103
1996	32,908	(1,860)	1,171	32,219	34,822	24,490	106	108
1995	28,168	(1,816)	1,126	27,478	28,000	21,887	99	102
1994	22,448	(1,216)	603	21,835	28,000	21,365	125	128

The total contributions required for SERS, TRS and SBRS are based on the entry age normal cost method using the same actuarial assumptions used to compute the net pension obligation.

*Subsequent Event – Change in Budgetary Funding for Pensions and Transfer of Assets*

On June 30, 2003, the Commonwealth enacted the General Appropriation Act (GAA) for fiscal year 2004. Within the Act, the Commonwealth changed its funding mechanism for its pension obligations, moving the funding “off – budget.” The original pension funding schedule called for an \$832.3 million appropriation. However, the fiscal year 2004 GAA amended the General Laws to allow annual pension appropriations to include the scheduled amount less the value of any capital assets transferred to the pension liability fund. The fiscal 2004 GAA funded the \$832.3 million pension obligation using \$687.3 million in cash from operating revenues and by the transfer of the Hynes Convention Center and the Boston Common Garage properties, valued at \$145.0 million.

*Post-retirement Health Care and Life Insurance Benefits*

In addition to providing pension benefits, under Chapter 32A of the Massachusetts General Laws, the Commonwealth is required to provide certain health care and life insurance benefits for retired employees of the Commonwealth, housing authorities, redevelopment authorities, and certain other governmental agencies. Substantially all of the Commonwealth’s employees may become eligible for these benefits if they reach retirement age while working for the Commonwealth. Eligible retirees are required to contribute a specified percentage of the health care benefit costs which is comparable to contributions required from employees. The Commonwealth is reimbursed for the cost of benefits to retirees of the eligible authorities and non-state agencies. The Commonwealth recognizes its share of the costs of providing these benefits when paid. These payments totaled approximately \$251,370,000 for the fiscal year ended June 30, 2003. There are approximately 51,398 participants eligible to receive benefits at June 30, 2003.

The Commonwealth has not performed an actuarial valuation of its post-retirement health care and life insurance benefit liability. Private industry typically sees an actuarial accrued liability of 10 to 20 times the current annual payments. For the Commonwealth this would extrapolate to an actuarial accrued liability of \$2.5 billion to \$5 billion.

The FY04 General Appropriation Act changed the employee contribution rates for group health insurance with the exception of current employees earning less than \$35,000 and retirees. Current employees as of July 1, 2003 will contribute 20% to their health insurance costs if they earn over \$35,000. New employees will contribute 25%. In fiscal 2006, the contribution rates will return to 15% for all employees.

## 11. LEASES

### *Primary Government*

In order to finance the acquisition of equipment, the Commonwealth has entered into various lease/purchase agreements, including tax-exempt lease purchase (TELP) agreements, which are accounted for as capital leases. Lease agreements are for various terms and contain clauses indicating that their continuation is subject to appropriation by the Legislature.

The Commonwealth has numerous operating lease agreements for real property and equipment with varying terms. These agreements contain provisions indicating that continuation is subject to appropriation by the Legislature.

The Colleges and the University lease real property and equipment under numerous operating lease agreements for varying terms.

The following schedule summarizes future minimum payments under non-cancelable leases for Governmental activities and for the Colleges and University – reported as a business-type activity, for the fiscal year ended June 30, 2003 (amounts in thousands):

Primary Government										
Fiscal Year Ended June 30	Governmental Activities					Business - Type Activities				Business -Type Activities Total
	Capital Leases		Operating Leases	Governmental Activities Total	Capital Leases		Operating Leases			
	Principal	Interest			Principal	Interest				
2004 .....	\$ 23,535	\$ 2,498	\$ 140,994	\$ 167,027	\$ 18,902	\$ 3,864	\$ 31,562	\$ 54,328		
2005 .....	18,637	1,978	122,315	142,930	15,950	3,093	28,948	47,991		
2006 .....	14,181	1,505	83,968	99,654	13,905	2,407	25,688	42,000		
2007 .....	9,398	998	56,691	67,087	12,631	1,799	24,123	38,553		
2008 .....	5,291	562	26,548	32,401	11,873	1,208	28,275	41,356		
2009 - 2013 .....	4,712	500	53,464	58,676	18,076	1,449	357,697	377,222		
2014 - 2018 .....	-	-	-	-	429	-	252	681		
2019 - 2023 .....	-	-	-	-	168	-	-	168		
Total lease obligations.....	75,754	8,041	483,980	567,775	91,934	13,820	496,545	602,299		
Less: current portion: .....	(23,535)	(2,498)	(140,994)	(167,027)	(18,902)	(3,864)	(31,562)	(54,328)		
Long - term lease obligations .....	\$ 52,219	\$ 5,543	\$ 342,986	\$ 400,748	\$ 73,032	\$ 9,956	\$ 464,983	\$ 547,971		

*Discretely Presented Component Units –*

The following is a schedule by years of future minimum lease payments under capital leases together with the present value of net minimum lease payments as of June 30, 2003 (amounts in thousands):

Fiscal Year Ended <u>June 30</u>	Massachusetts Bay Transportation <u>Authority</u>	Nonmajor <u>Component Units</u>	<u>Total</u>
2004 .....	\$ 48,479	\$ 746	\$ 49,225
2005 .....	41,401	748	42,149
2006 .....	42,448	745	43,193
2007 .....	47,907	742	48,649
2008 .....	53,017	5	53,022
2009 - 2013 .....	310,258	-	310,258
2014 - 2018 .....	270,694	-	270,694
Lease obligations .....	814,204	2,986	817,190
Less: Interest portion: .....	(261,382)	(337)	(261,719)
Present value of minimum lease payments .....	552,822	2,649	555,471
Less: current portions .....	(17,164)	(606)	(17,770)
Long - term lease obligations .....	<u>\$ 535,658</u>	<u>\$ 2,043</u>	<u>\$ 537,701</u>

The MBTA has entered into several sale-leaseback agreements with major financial institutions, covering equipment and rolling stock, which has been accounted for as operating leases. These leases expire through fiscal year 2013. Upon termination, the MBTA may purchase the equipment and rolling stock at prices equal to the lesser of a stated percentage (40%-70%) of the lessor's original purchase price or residual fair market value, as defined.

The MTA has operating leases for administrative office space and automatic toll collection equipment. These operating leases expire on various dates through June 2004. Lease expenses charged to the Massachusetts Turnpike and Sumner-Callahan-Williams Tunnels were approximately \$974,000 of which \$862,000 was paid to the Commonwealth for office space in a state-owned building.

The MTA leases property and air rights to others. The MTA earned approximately \$29,300,000 in rental income of which \$14,000,000 was received for restaurant, concessions and service station rentals.

The Economic Development Entities and the RTAs have operating leases for office space.

The future minimum rental payments required under operating leases having initial or remaining non-cancelable lease terms in excess of one year are as follows (amounts in thousands):

Fiscal Year Ended <u>June 30</u>	Massachusetts Bay Transportation <u>Authority</u>	Massachusetts Turnpike <u>Authority</u>	Nonmajor <u>Component Units</u>	<u>Total</u>
2004 .....	\$ 13,875	\$ 869	\$ 2,384	\$ 17,128
2005 .....	12,864	896	1,348	15,108
2006 .....	13,130	455	1,223	14,808
2007 .....	13,499	-	694	14,193
2008 .....	13,471	-	1,039	14,510
2009 - 2013 .....	57,283	-	932	58,215
2014 - 2018 .....	-	-	166	166
2019 - 2023 .....	-	-	74	74
2024 - 2028 .....	-	-	4	4
Total lease obligations .....	<u>\$ 124,122</u>	<u>\$ 2,220</u>	<u>\$ 7,864</u>	<u>\$ 134,206</u>

## 12. COMMITMENTS

### A. *Commitments to Discretely Presented Component Units and Other Entities*

As part of the General Appropriation Act of 2000 (Chapter 127 of the Acts of 1999) the funding mechanism for the net cost of service and other costs of the Massachusetts Bay Transportation Authority (MBTA) was changed. The change was effective July 1, 2000. Under the new funding method (Forward Funding), the MBTA's costs will be funded on a current basis. This method apportions a "dedicated sales tax" amounting to 1% of applicable sales in the Commonwealth, directly to the MBTA. The dedicated sales tax will be equal to the greater of the amount raised by the sales tax or \$645,000,000, (the base revenue), subject to an adjustment for inflation, capped at 3% annually. For FY04, the base revenue is \$684,280,500.

In addition, the Commonwealth guarantees the debt of certain local governments and public higher education building authorities. The majority of these guarantees are for bonds outstanding for certain series' of the University of Massachusetts Building Authority. The Commonwealth guarantees these series of bonds to a maximum of \$200 million.

At June 30, 2003, the Commonwealth had commitments of approximately \$976,620,000 related to ongoing construction projects. The majority relate to construction funding for the Central Artery/Tunnel Project. The Central Artery/Tunnel Project continues to anticipate federal participation and payments from the Massachusetts Turnpike Authority (MTA) and the Massachusetts Port Authority (MassPort).

The Commonwealth continues to guarantee certain Massachusetts Bay Transportation Authority (MBTA) debt outstanding at June 30, 2003, totaling \$2,833,700,000. The amount represents the residual balance of Commonwealth guaranteed debt that existed prior to the forward funding.

The MBTA's forward funding legislation provides for the MBTA to issue general obligation, revenue or other debt secured by a pledge or conveyance of all or a portion of revenues, receipts or other assets or funds of the MBTA. This new debt is not backed by the full faith and credit of the Commonwealth. Finally, the MBTA will not receive any principal or interest subsidies from the Commonwealth for the repayment of either the prior debt or new debt of the MBTA beyond the pledged revenues.

In addition to the MBTA, the Commonwealth guarantees debt of a number of Public Authorities. At June 30, 2003, the aggregate outstanding debt for which the Commonwealth is obligated to provide contract assistance support totaled approximately \$909,167,000 long-term and \$100,596,000 short-term.

Under Chapter 161B of the General Laws, the Commonwealth is obligated to provide annual subsidies to certain regional transit authorities (RTA's) for contract assistance, debt service assistance and their net cost of service deficiencies. The Commonwealth recovers a portion of these payments through assessments to the cities and towns served. During FY03, net expenditures were \$18,580,000. In addition, for FY03, the Commonwealth appropriated \$19,478,000 to the regional transit authorities to cover net costs of service for the calendar year ended December 31, 2002.

The FY03 General Appropriation Act amended Chapter 161B. After July 1, 2003, bonds and notes issued by the various RTA's are no longer guaranteed by the Commonwealth and are not general obligations of the Commonwealth.

**B. *Saltonstall Building***

The Massachusetts Development Finance Agency (MDFA) was authorized in legislation to undertake redevelopment of the Saltonstall State Office Building and its surrounding area. Under the provisions of MDFA's bond authorization, the building is to be leased by the MDFA for a lease term of up to 50 years with extension terms permitted for an aggregate 30 more years. The MDFA renovated the building and will lease half of it back to the Commonwealth for office space and related parking for a comparable lease term. The remainder of the building and surrounding area has been redeveloped as private office space, housing and retail establishments. Upon completion, the Commonwealth will be obligated for future lease payments for space it rents. However, this obligation is not a general obligation or a pledge of credit of the Commonwealth. Though MDFA's bonds are revenue obligations, with pledges of the public and private lease payments, the Commonwealth's lease payments are due upon occupancy and are subject to annual appropriation. It is currently anticipated that the initial lease payment will be due between December of 2003 and February of 2004. The Governor filed legislation in June 2003 to fund the cost of the FY04 lease payments. The legislation is currently pending.

**C. *Central Artery / Tunnel Project***

The Central Artery / Tunnel Project is the largest single component of the Commonwealth's capital program according to the finance plan filed as of October 1, 2003. The current cost estimate is \$14.625 billion. The plan includes a maximum obligation of \$8.549 billion from the federal government. The finance plan is currently under review.

- D. Pension Trust Funds** At June 30, 2003, PRIT had outstanding commitments to invest approximately \$1,570,000,000 in alternative investments and \$100,000,000 in distressed debt. The fair value of the proposed investment commitments approximates their stated value.
- E. Commitments of Discretely Presented Component Units** Chapter 152 of the Acts of 1997 provides \$609,400,000 for the construction of a Convention and Exhibition Center that will provide 600,000 square feet of exhibit space at a site in South Boston. The Boston Redevelopment Authority (BRA) is authorized and directed by the legislation to acquire the land, properties, and rights related to the proposed construction site. Once this is accomplished, the Massachusetts Convention Center Authority (MCCA) will oversee construction of the new facility. The MCCA will operate the new center, the Springfield Civic Center, along with the Hynes Convention Center and the Boston Common Garage on behalf of PRIT.
- As of June 30, 2003, the Massachusetts Water Pollution Abatement Trust (MWPAT) has agreed to provide loans of \$33,262,000 to various local government units to be funded with grant awards.
- The MTA entered into construction contracts for the Metropolitan Highway system and the Western Turnpike with various construction and engineering companies. Construction contracts outstanding at December 31, 2002 approximated \$13,000,000.

### 13. CONTINGENCIES

#### *Primary Government -*

Governmental Funds – The General Fund services claims for all risks of loss for which the Commonwealth is exposed, other than workers' compensation and employee group health and life insurance, which are managed in its general operations. A number of lawsuits are pending or threatened against the Commonwealth which arose from the ordinary course of operations. These include claims for property damage and personal injury, breaches of contract, condemnation proceedings and other alleged violations of law. For cases in which it is probable that a loss will be incurred and the amount of the potential judgment can be reasonably estimated, or a settlement or judgment has been reached but not paid, the Attorney General estimates the liability to be approximately \$52,196,000 as of June 30, 2003. The General Fund allocates the cost of providing claims servicing and claims payment by charging a premium to each fund based on claims paid during the year.

The Commonwealth receives significant financial assistance from the federal government. Entitlement to these resources is generally conditional upon compliance with terms and conditions of the grant or reimbursement agreements

and with applicable federal regulations, including the expenditure of the resources for eligible purposes. Substantially all federal financial assistance is subject to financial and compliance audits. Any disallowances become liabilities of the fund that received the assistance. As of June 30, 2003, the Commonwealth estimates that liabilities, if any, which may result from such audits are not material.

The Commonwealth's abandoned property law requires deposit of certain unclaimed assets into a managed Fiduciary Fund. These unclaimed assets, less \$6,907,000 that is expected to be reclaimed and paid in fiscal year 2004, are to be remitted to the General Fund each June 30, where it is included as a transfer. Amounts remitted during fiscal year 2003 totaled approximately \$103,803,000. Since inception, approximately \$1,160,167,000 has been remitted. This represents a contingency, because claims for refunds can be made by the owners of the property.

**A. Tobacco Settlement**

The Master Settlement Agreement (MSA) was executed in November of 1998 between five tobacco companies and 46 states, including the Commonwealth. The MSA called for, among other things, annual payments to the states in perpetuity. These payments have been estimated to total more than \$200 billion over the first 25 years, subject to various offsets, reductions, and adjustments.

In FY03, the Commonwealth received approximately \$300,039,000 or 89% of the base amounts, before adjustments including for volume and fluctuations in the consumer price index, as shown in the agreement. All amounts received were transferred to the Tobacco Settlement Fund, a budgeted fund, plus an additional \$7,763,000 in interest earnings pursuant to the General Laws. The majority of expenditures from the fund this year was for Health and Human Services, Elder Affairs and Medicaid costs. Pursuant to the FY03 General Appropriation Act an additional \$162,000,000 was transferred from the Tobacco Settlement Fund to fund Health and Human Services expenditures primarily in the Uncompensated Care Fund and the Children's and Seniors' Health Care Assistance Funds.

The amounts that might be payable, if any, by the Commonwealth for legal costs relating to the tobacco litigation cannot be determined at this time. The outside attorneys for the Commonwealth were awarded approximately \$775,000,000 in fees to be paid over time by the tobacco companies and, therefore, were not to be paid out of the Commonwealth's award. However, they have filed a breach of contract action against the Commonwealth seeking damages and declaratory and injunctive relieve based on the Commonwealth's alleged failure to comply with a contingent attorney's fee agreement in connection with the plaintiff law firms' representation of the Commonwealth against the tobacco industry. On December 19, 2003, the jury returned a verdict, which eliminates any exposure of the Commonwealth to an immediate obligation to make any payment. If this judgment becomes final, the likelihood that the Commonwealth will have to pay any sum on the claim will depend on the actual payments received by the Commonwealth under the MSA up through 2025.

**B. Unemployment Compensation Fund**

The fund balance in the Unemployment Compensation Fund has declined to approximately \$491 million as of June 30, 2003. The Department of Employment and Training estimates that the fund will be operating at a deficit by January 2004. State law provides that in the event of a deficit in the Unemployment Compensation Fund that is not paid back by September 2004, additional revenues will be collected from employers in order to pay the interest

that has accrued on the debt.

**C.      *Central  
Artery/Tunnel  
Project – Owner  
Controlled Insurance  
Program (OCIP)***

The Commonwealth of Massachusetts has assumed responsibility for providing worker's compensation and general liability insurance for all eligible contractors and subcontractors working on the Central Artery/Tunnel Project by establishing an Owner Controlled Insurance Program in 1992.

In 1996 the Highway Department established a trust managed and administered by an independent third party (trustee) to protect a portion of the assets set aside with the insurance carrier to fund project liabilities.

The amounts in the Trust are restricted by its terms and cannot be used for other purposes. The withdrawals, other than those to cover costs specified by the Trust Agreement, require mutual consent. Any amounts that remain in the Trust after all losses and other obligations of the Project are paid will be repaid to the Project for distribution in accordance with funding agreements with the federal government. During FY03 federally funded fund assets were replaced by state assets and therefore are no longer restricted as to the ultimate distribution at the end of the Project.

The Project's OCIP activity is reported as a minor governmental (capital project) fund. The "Claims and Judgements" liabilities reported within the fund represents the Project's liabilities as estimated by an independent actuary for incurred losses projected to their ultimate value as of the end of the fiscal year for FY03. The remaining liability is reported as part of the non-current liability in the statement of net assets.

As of June 30, 2003, the OCIP has accumulated approximately \$245,000,000 in assets that consist of approximately \$190,000,000 in cash and investments, approximately \$53,000,000 in funds held by the investment provider and approximately \$2,000,000 in interest income receivable. Net assets at year – end of approximately \$124,500,000 were restricted for workers' compensation and general liability claims.

The OCIP's assets are to be available to pay the obligations under the programs. These insurance programs are presently structured as retrospectively rated insurance programs with retained loss limits of \$1,000,000 per claim, \$3,000,000 per occurrence for worker's compensation and \$2,000,000 per enrolled contractor or other named insureds, \$6,000,000 per occurrence for general liability coverage. The Commonwealth is responsible for loss costs up to these amounts.

The estimated Claims and Judgements liability for the OCIP for occurrences through June 30, 2003 is \$108,200,000, of which \$32,500,000 is presented as a current liability in the minor governmental fund, while the remaining \$75,700,000 is presented on the statement of net assets. This amount is based on the results of a review performed by an independent actuarial firm retained by the Project, and it represents an estimate of liabilities incurred based on past experience for claims reported and not reported as of June 30, 2003. The estimate of \$108,200,000 does not reflect the maximum potential obligation of the Project to the end of the Project.

**D. Claims and Judgments**

The following amounts were recognized as of June 30, 2003 (amounts in thousands):

	Balance as of July 1, 2002	Additions	Reductions	Balance as of June 30, 2003
Short-term.....	\$ 144,000	\$ 84,696	\$ 144,000	\$ 84,696
Long-term.....	175,100	75,700	175,100	75,700
	<u>\$ 319,100</u>	<u>\$ 160,396</u>	<u>\$ 319,100</u>	<u>\$ 160,396</u>

**E. Discretely Presented Component Units**

The MBTA reserves self-insurance liabilities as claims and judgements as of June 30, 2003. Changes in the self-insurance reserves in fiscal 2003 and 2002 were as follows (amounts in thousands):

	2003	2002
Liability, beginning of year.....	\$ 86,644	\$ 69,476
Current year claims and changes in estimates.....	103,949	114,651
Claims payments.....	<u>(101,756)</u>	<u>(97,483)</u>
Liability, end of year.....	<u>\$ 88,837</u>	<u>\$ 86,644</u>